Competition and Solvency

A Framework for Financial Regulation

Economic Council of Canada
1986

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Foreword

The Canadian financial system plays a vital role in the operation of the Canadian economy as a whole. Its sound and efficient functioning has long been of considerable concern to the Economic Council of Canada. The Council previously published three major reports dealing with particular financial issues. Its 1976 report on deposit institutions, *Efficiency and Regulation*, was released prior to the decennial review of the *Bank Act*. This was followed in 1979 by *One in Three*, an examination of questions surrounding the operation of the Canadian pension system. In 1982, the Council published *Intervention and Efficiency*, a study of government credit and credit guarantees available to the private sector. The Council has also looked at financial matters in the context of other reports, the most recent examples being its 21st Annual Review (1984), which included an analysis of government finances, and the 22nd Review (1985), which examined the conduct of Canadian monetary policy in the context of the growing internationalization of financial markets.

In March 1985, the Council was prompted by a number of factors to launch a sweeping study of all of the main facets of the Canadian financial system. Foremost among them was the fact that far-reaching changes were occurring in the operations and scope of activities of financial institutions. While many of these changes were welcome because they contributed to greater competition, improved efficiency, and the provision of new services designed to meet new consumer requirements, they also included developments that were cause for growing concern on several counts. Many of the changes were such that financial institutions were able simply to escape federal and/or provincial regulatory controls; others significantly reduced the effectiveness of the existing regulatory mechanisms. Also, a succession of failures in the financial industry inevitably raised pressing questions about the continuing soundness of the financial system as a whole. We concluded that an in-depth examination should be undertaken in order to arrive at proposals aimed at improving the effectiveness of regulatory control over the financial system and at strengthening public confidence in its stability. The proposals should also aim at providing ample scope over the years to come for continuing improvement in the efficiency of the system and its ability to adapt to the changing needs of the Canadian people and to the rapid evolution of financial markets at home and abroad.

In undertaking this comprehensive review of the operations of the financial system today and the current state of federal-provincial regulation, we have benefited substantially not only from the information and analysis that flowed from our own previous examination of the subject, but also from the many studies of various aspects of the system by federal and provincial sources that have been made public over the past 18 months. (A comparison of the objectives and conclusions of these bodies with those of the Council's own previous studies of financial issues appears in the Appendix to this report.) In a number of respects, we have come to quite different conclusions than those contained in these various reports. In some cases, this may reflect a difference in judgment on our part, resulting from new lessons learned with the passage of time or from the broader perspective that we have adopted. Indeed, it is those very factors that have led us to modify somewhat the conclusions that we reached in our 1976 report on deposit institutions.

This report contains a synthesis of the extensive factual study and analysis undertaken to provide a basis for the 31 proposals for strengthening the Canadian financial system that have been formulated by the Council. The detailed research findings that provide the foundation for these conclusions will be published shortly in a companion volume, entitled *A Framework for Financial Regulation*. The measures we are advocating would, if implemented, affect the operations of every sector of the financial industry, as well as the responsibilities of the federal and provincial agencies that regulate them. To a considerable extent, our recommendations are formulated so as to take careful account of the close interrelationship of the financial system as a whole. They are aimed at providing a rational and coherent framework for the regulation of the different sectors of the system – a framework that would, at the same time, treat each of them in an even-handed way. They are also intended to provide a substantial element of flexibility so as to enable the regulatory system to accommodate the competitive changes that will undoubtedly continue to occur in financial markets for many years to come.

The recommendations we are putting forward are necessarily of a general nature and make no attempt to encompass all the legal, legislative, and administrative provisions that would have to accompany their implementation. We recognize that these matters must be worked out through detailed discussions between governments and the various groups of financial institutions. We are confident, however, that the adoption of the broad thrust of our proposals would contribute significantly both to the strengthening of public confidence in the soundness of Canadian financial institutions and to the development of a system that is world-class in terms of competitiveness and effectiveness.

On behalf of the Council, I would like to thank the Advisory Committee, composed of four Council members and five outside experts. (Together, they represented the major financial institutions and consumer interests.) The Committee acted as a valuable sounding board, providing guidance to the research team and refining the recommendations in this statement. In particular, I want to thank Peter Podovinikoff, Chief Executive Officer, Delta Credit Union, who participated in the work of the Advisory Committee until his term as a Council member expired in September. His energy and leadership were key factors in building consensus around the Council table.

Judith Maxwell
Chairman

(Note: A glossary of the major technical expressions found in the text appears at the end of this report.)

Competition and Solvency

Evolution of the Financial System

The Early Postwar Period

Once upon a time – and not so many years ago, at that – the Canadian financial system was relatively simple and uncomplicated. It was built on four main "pillars" – the chartered banks, the trust companies, the insurance companies, and the securities industry – all of which were closely regulated by separate federal or provincial agencies or departments. The activities undertaken by each of these pillars were comparatively straightforward, and there was little or no overlapping of their respective functions (see the Glossary for the definition of functions).

Somewhat ironically, in light of present-day circumstances, the creation of a financial system built upon those four separate pillars evolved largely because of concerns about the soundness of the then-existing system and the protection it afforded lenders, investors, and borrowers. These concerns had grown out of such developments as the failure of the Home Bank in 1923 and the serious pressures to which the system had been subjected during the Great Depression.

Under the pillar system, the chartered banks, which were regulated federally, were mainly confined to a narrow concept of banking – primarily the collection of short-term funds in the form of demand deposits and the provision of loans to business for the financing of inventories and accounts receivable. The main activity of trust companies was the management of estate and trust funds, including pension funds, although they also accepted term deposits and provided some mortgage financing. The insurance companies engaged in the business of selling insurance (life, property, casualty, and so on). Investment dealers undertook commissioned buying and selling of stocks and bonds, as well as the underwriting of new security issues. Trust and insurance companies could be incorporated and regulated at either the federal or provincial level, while the securities industry came under provincial jurisdiction only. Financial cooperatives – the caisses populaires and credit unions – catered to the basic needs of local communities and were subject to provincial control.

This separation of the functions authorized for each pillar was designed to restore confidence in the soundness of the financial system, badly shaken by events in the 1920s and 1930s. In addition, the division between commercial lending and trust activities and between banking and dealing in securities was intended to minimize the potential for the development of conflicts of interest. As a means of ensuring the solvency of financial institutions and thus enhancing public trust in their soundness, regulations not only limited the activities in which particular sectors of the system could engage, but they also prescribed the extent to which the institutions could assume certain liabilities. As a further means of protecting the interests of consumers, which was the ultimate concern, the laws and regulations imposed ceilings on certain interest rates and provided a further, more general measure of protection through provisions intended to prohibit usury.

Regulation is twofold in its nature: it involves both the establishment of certain rules and the creation of an administrative mechanism to ensure compliance with those rules. Regulation in Canada has traditionally been a blend of direct government regulation, corporate governance by individual firms, and self-regulation by a particular industry. The historical

Approaches to Regulation

There are three basic approaches to the regulation of financial institutions:

Direct government regulation, in which the rules and regulations governing the behaviour of financial institutions are set down in law by government and government officials ensure compliance with these rules. The *Bank Act*, the operation of the Office of the Inspector General of Banks and of the *Ontario Trust and Loans Companies Act*, and the Ontario Ministry of Financial Institutions are examples.

Corporate governance, in which the management and directorate of a financial institution are structured, and its own rules and regulations are formulated, so as to achieve the desired corporate behaviour. An example is the institution of, and powers given to, committees of the boards of directors to supervise various aspects of the business of the financial institutions. Audit committees and committees to oversee non-arm's-length transactions are cases in point.

Self-regulation, in which an association of financial institutions sets out rules and regulations by common agreement and assumes the enforcement power. The rules and regulations applying to members of the various stock exchanges are examples.

cooperation between senior management and the external auditors of chartered banks, the Canadian Bankers Association, and the federal Office of the Inspector General of Banks is a case in point.

The Acceleration of Change

Beginning in the 1960s, a gathering consensus emerged in support of establishing a further primary objective for the financial system, in addition to those of solvency and consumer protection – namely, that of ensuring competition among financial institutions. This was one of the dominant considerations behind the far-reaching changes that were made in the *Bank Act* in 1967. Two of the revisions were particularly significant. One was the abolition of interest rate ceilings, which enabled the chartered banks to move strongly into the field of consumer loans. The other was an amendment allowing the banks to engage in the field of conventional mortgage loans, which led to a substantial increase in competition in that market. Additional regulatory changes were aimed at expanding the information available to the consumer.

These and other legislative changes have paved the way for a weakening of the often rigid division of

The Financial Institutions of the 1980s

The *chartered banks* operating under Schedule A of the *Bank Act* are the better known of today's financial institutions as they play a key role in the retail side of financial services. Besides offering various kinds of deposits redeemable at face value and/or transferable by cheque, banks provide many other services such as safekeeping, the issuance of letters of credit, and the purchase of securities and registered retirement savings plans. The funds raised through deposits are mainly channeled into non-marketable instruments such as business, consumer, and mortgage loans. Banks participate in the underwriting of government securities, and they are involved in the supply of information in various forms – from advice to individuals on the availability and characteristics of savings instruments to assistance provided to businesses, particularly small businesses, in managing their financial affairs. Canadian banks are very active abroad, where they accept deposits and extend loans and where they also participate in the underwriting of corporate securities and in syndicated loans. The subsidiaries of foreign banks that operate under Schedule B of the *Bank Act* provide similar services, although they are not as active on the retail side of banking.

Trust companies have gained in relative importance as their deposit-taking activities have grown over a number of years. Most of the funds raised are invested in mortgages, but some find their way into corporate bonds and shares, government bonds, and business loans. The administration of estates is also an important activity. In addition, trust companies manage mutual funds, registered retirement saving plans (RRSPs), pension funds, and personal and corporate trusts.

Life insurance companies are involved in retail operations through the sale of life insurance policies (including annuity contracts), the proceeds of which are channeled into mortgages, government and corporate bonds, and (to some extent) corporate shares. They are also involved in the management of pension funds and mutual funds, particularly those used as vehicles for RRSPs. Property and casualty insurers invest funds raised through the selling of fire, theft, and accident policies in government bonds and in corporate bonds and shares.

Investment brokers and dealers act as intermediaries between the buyers and sellers of securities and maintain a market for bonds and stocks. They also hold portfolios of securities and transact on financial markets in their own behalf. As underwriters, they assist in the raising of funds by governments and corporations. They also provide a wide variety of information on the economy as a whole, on specific sectors of activity, and on the financial situation of many companies.

Caisses populaires and *credit unions*, sometimes considered the fifth pillar of the Canadian financial system, offer many of the same services as chartered banks, collecting deposits and investing in mortgages, consumer loans, and (to a lesser extent) business loans.

But the Canadian financial system does not limit itself to the four or five pillars. Other institutions are active in many different markets. *Mortgage loan companies*, mainly associated with Schedule A banks, invest funds raised through term deposits in mortgages and especially residential mortgages. *Mutual funds* and *closed-end funds* offer investors the possibility of investing their savings in a diversified portfolio of corporate and government securities and mortgages. They also free individuals from the need to closely manage their securities portfolios. *Financial corporations* provide credit to individuals, retailers, and wholesalers, and they also provide industrial loans and financing for inventories and capital expenditures. *Venture capital firms* and *merchant bankers* provide more-risky capital, often in the form of equity. Pension funds receive contributions from individuals and their employers, and invest them in a broad range of assets. *Investment counsellors* assist financial institutions in the management of funds. *Financial planners* help individuals in organizing their own finances and in setting up portfolios of securities that best correspond to their needs.

functions separating the pillars of the financial system. Today, it is possible to buy stocks from a bank, establish a demand deposit account (a classic function of banking) with an investment dealer, and acquire short-term deferred annuities (also remarkably similar to traditional banking instruments) from life insurance companies. By the same token, it is also possible to acquire mutual funds from a bank, a credit union, a life insurance company, a trust company, an investment dealer, and a financial planner.

The erosion of the demarcation lines between the financial pillars has been accompanied and stimulated by a number of mergers that have taken place between financial institutions and by the emergence of conglomerates as an important force in financial markets. Also of importance is the growth of holding groups, which have come to play a major role on the financial stage by bringing together under a single corporate umbrella one or more trust companies, life insurance firms, mutual funds, investment counsellors, general insurance companies, and even investment dealers and banks. In addition to controlling financial institutions, many of these holding groups are also associated with major non-financial corporations. Other developments have further contributed to the growing complexity of the financial system. These include networking arrangements, under which one institution provides facilities to sell the product of another institution; cross-referrals, whereby one institution refers potential customers to another with respect to the availability of particular services; and the creation of what have come to be known as "financial supermarkets."

All of these developments have been accompanied by the creation of a bewildering array of new financial instruments. They include such devices as daily-interest savings and chequing accounts, cash-management accounts, and T-Bill passbook savings accounts, to name but a few deposit instruments. On the mortgage side, there are instruments that provide for weekly, bi-weekly or bi-monthly payments; multiple-term mortgages; gradual-payment mortgages; variable-rate mortgages; and indexed mortgages. The securities business has witnessed the emergence of such instruments as floating-rate preferred shares; income debentures; stripped bonds; so-called "junk bonds," involving a high yield and high risk; and financial futures. In the insurance field, universal life policies have been introduced in order to separate the insurance

The Growing Importance of Financial Holding Groups in Canada, 1979-85

	Total assets[1]		
		Proportion of total for all financial institutions[2]	
	Value in 1985	1979	1985
	($ millions)	(Per cent)	
Desjardins Group	26,368	2.94[e]	3.33
Trilon Financial Corporation	20,830	...	2.63
Power Financial Corporation	15,948	1.65	2.01
Crown Financial Group	6,103	0.50	0.77
Laurentian Group[3]	5,167	0.37	0.65
Traders Group	4,460	0.76[e]	0.56
Eaton Financial Services[4]	1,061	0.15	0.13
E.L. Financial Corporation[5]	1,118	0.12	0.14
Groupe Prêt et Revenu[6]	503	0.04	0.06
Total	81,558	6.54[e]	10.29

e estimate.
... not applicable.
1 The assets of the financial holding companies are presented on a non-consolidated basis, unless otherwise stated; the estate, trust, and agency business is not included.
2 The assets of the trusteed pension plans have been excluded.
3 In 1985, the Laurentian Group also owned 29.5 per cent of the shares of the Montreal City and District Savings Bank and its wholly owned subsidiary, Crédit Foncier. As of 31 October, the consolidated assets of the bank amounted to $6.2 billion. In 1986, Montreal Trustco, which is a subsidiary of Power Financial Corporation, acquired Crédit Foncier.
4 Eaton Financial Services was acquired by the Laurentian Group Corporation in 1986.
5 The assets are presented on a consolidated basis.
6 The assets are presented on a consolidated basis in 1985 and on a non-consolidated basis in 1979.
SOURCE Chapter 3 of *A Framework for Financial Regulation*.

component from the savings component of the policy, the objective being to enable insurance companies to compete more effectively against other institutions for the funds of the Canadian public. Banking is also moving a step closer to the securities business, with the beginning of "securitization" – a process by which, in Canada, mortgages are bundled together in security pools for the purpose of creating units for sale to private or corporate investors, thus significantly increasing the liquidity of these kinds of assets.

The Impact of International Developments

The development during the postwar period of a highly competitive global financial market had major implications for the Canadian financial system. In part, the system grew by leaps and bounds in response to the commensurate increase in the volume of world trade in goods and services. But it also grew in size and complexity in response to the international demand for long-term capital and to take advantage of new facilities that developed around the world for the profitable investment of short-term funds. A number of interrelated factors were behind these developments, including the massive increase in global liquidity that resulted from the accumulation of vast amounts of so-called petro-dollars and from far-reaching advances in technology.

International and domestic financial markets have undergone major changes in accommodating a series of upheavals. The latter include the sharp upsurge of inflation of the 1970s and early 1980s, the substantial increase in global liquidity and the subsequent heavy loans to many less-developed countries, the adverse impact of severe recession, the tumbling of world oil prices, disinflation, the consequent development of an international debt crisis – and all of the changes in investor behaviour that these events have engendered.

Canadian financial institutions have long been highly exposed to international developments. In comparison with many other countries, our financial markets have always been very open. A number of our financial institutions have, for years, looked beyond our borders for opportunities to expand their operations. Today, life insurance companies and the chartered banks, in particular, operate in many countries around the globe, and foreign assets constitute a large proportion of the total assets of many Canadian banks.

As international financial markets have expanded in breadth and scope, they have become increasingly sophisticated – a process that has been made possible by new technological developments involving computers and communications. Opportunities for hedging so as to safeguard funds invested abroad in foreign currencies against adverse exchange-rate movements and for taking advantage of price differentials in different markets through arbitrage have grown substantially. The operations of international clearing houses have also expanded rapidly. All of these developments have led many companies to engage in round-the-world cash-management currency swaps and other complex options as part of their regular financial strategy.

Many large Canadian companies and investors have come to the conclusion that financial institutions based in such centres as New York, London, or Tokyo are in a better position to meet their financial needs – institutions that are, of course, beyond the purview of Canadian regulatory authorities. Because of the substantial number of problem loans on their books, the credit ratings of many international banks have dropped below those of some of the large, non-financial multinational corporations. Because of the difficulty they face in competing to provide loans themselves under these circumstances, many of these banks have undertaken the role of a market intermediary by bringing together a potential borrower and a potential lender. In this, the role of the banks is similar to that of securities firms. Through subsidiaries based abroad, several Canadian banks are also engaged in merchant banking – an activity they are precluded from undertaking at home.

Emerging Problems

Partly because of the growing internationalization of financial transactions and other developments, a number of factors have contributed to the increasing problems facing the regulating agencies in recent years. Prior to 1967, trust companies and financial cooperatives were increasing their deposit-taking activities and, in this sense, challenging the traditional role of the chartered banks. The 1967 amendments to the *Bank Act*, which spurred additional competition in the system, further contributed to the blurring of the traditional division of functions that had for some years existed between each of the pillars. The successful entry of the chartered banks into fields previously served by others marked the beginning of a growing competition among all of the institutions to at least maintain – and, if possible, to increase – their share of the total financial market. Until the early 1980s, the revisions to the *Bank Act* of 1967 and 1980 represented the only major changes made in the regulatory provisions governing the financial system as a whole, at both the federal and provincial levels. More recently, the province of Quebec introduced legislation governing insurance, while Ontario is considering legislation governing trust and loan, and securities activities. The demarcation lines between the pillars continued to be

progressively eroded, however, as institutions vigorously expanded their operations into areas that were once considered the exclusive preserves of others.

This weakening of the regulatory system was caused by several major factors. The first had to do with the creation of new instruments that could not be readily categorized in terms of the financial function that each pillar was authorized to undertake. The problem was further compounded by the growing complexity of the marketplace and the increasingly important role played by conglomerates and holding groups that bring together both financial and non-financial interests under a single corporate roof. No less important was a third factor: the adoption by the authorities of an approach that might be designated as "regulation by looking the other way." Rather than actively applying the law as it existed, regulators increasingly gave tacit consent to the undertaking of new activities by various institutions – activities that in many cases were intended to circumvent the law in an effort to meet emerging new market demands or simply to preserve or expand their competitive position.

An additional factor that has served to undermine the effectiveness of the system for governing financial markets has been the division of jurisdiction between federal and provincial governments, and the lack of harmonization between provincial authorities. Although trust and insurance companies come under either provincial or federal jurisdiction, there is no uniformity in the standards applied by the various regulatory authorities. Only in Quebec, Ontario, Alberta, and British Columbia have reasonably comprehensive regulations been adopted. In some cases, the capacity of provinces to regulate is limited by their inability to control the movement of funds outside their borders. The very fact that jurisdiction is divided among various governments has likely contributed also to the inertia of the respective authorities in overhauling the existing regulatory system. There is also inconsistency in the application of regulations between the provinces.

Failures of Financial Institutions

The clearest and most compelling symptoms of the underlying problems that have developed in the Canadian financial system are the initiatives taken by financial institutions to bypass existing regulations. But equally dramatic in the public eye have been the growing number of failures that occurred in the late 1970s and the early 1980s, and the way the failures were handled. Between 1980 and 1985 alone, 22 financial institutions failed in this country. The year 1985 was particularly difficult, for it marked the collapse of two chartered banks – the Canadian Commercial Bank and the Northland Bank, both based in Alberta – the first such failures since that of the Home Bank in 1923. In the same year, five trust and loan companies and two general insurance companies also failed. As a result of these developments, some of the other smaller Schedule A chartered banks also came under pressure because of the heavy withdrawal of deposits. It was in such a context that the Mercantile Bank of Canada merged with the National Bank in 1986, that the Morguard Bank was taken over by the Security Pacific Bank, and that the Continental Bank initiated a merger with the Canadian subsidiary of Lloyds Bank of London. Although no failures have occurred in the securities industry, about 20 mergers and acquisitions between 1981 and 1985 were prompted by the actual or prospective problems confronting at least one of the firms involved in each case.

Occasional failures of financial institutions need not, in themselves, be a matter for concern. Indeed, they may be inevitable in a dynamic, competitive, and effective financial system. The large number of failures in recent years, however, points to the existence of serious underlying problems in the system as it now exists. These failures inevitably invite re-examination of the role of the Canada Deposit Insurance Corporation in cushioning the adverse impact of losses. As the experience of the 1920s and 1930s demonstrated for those who had forgotten the lesson, public trust and confidence in the soundness and stability of the financial system are crucial to its successful operation. The public must also be confident that, given the opportunities that exist in the industry for self-dealing or for other abuses at the expense of depositors or shareholders, their interest is being protected.

In our judgment, public confidence in the system as a whole remains strong. The recent rash of failures, however, cannot be ignored. Admittedly, the adverse economic developments of the late 1970s and early 1980s created serious difficulties for most elements of the Canadian economy, but our analysis indicates that most of the failures of financial institutions were primarily the result of errors of judgment on the part of management (see Chapter 4 of *A Framework for Financial Regulation*, the forthcoming companion Research Report by the Economic Council of Canada). This included the taking of excessive credit and funding risks, and the mismatching of assets and liabilities. In certain cases, the risk of insolvency was aggravated by the failure to take account of an erosion of the capital base in relation to total liabilities, which may result from loan losses or from the failure to take account of contingent liabilities.

Regulatory Problems

While the various bodies charged with the responsibility of supervising financial institutions are armed

Factors That Contributed to the Failure of Various Financial Institutions, Canada, 1980-85

		Internal factors						
		Management errors						
	Year of failure	Inadequate management of assets	Inadequate management of liabilities	Insufficient diversification	Mismatching of assets and liabilities	Erosion of the capital base	Questionable practices	External factors: economic environment
Chartered banks								
Canadian Commercial Bank	1985	x	x	x		x		x
Northland Bank	1985	x	x	x		x		x
Federally chartered trust and loan companies								
Astra Trust Co.	1980	x		x			x	
Dial Mortgage Loan Co.	1981	x						
Fidelity Trust Co.	1983		x	x	x			x
AMIC Mortgage Investment Corp.	1983	x		x		x	x	x
Greymac Mortgage Corp.	1983	x	x	x			x	
Seaway Mortgage Corp.	1983	x	x	x			x	
Northguard Mortgage Corp.	1985	x		x		x		x
Pioneer Trust Co.	1985	x	x	x		x		x
Western Capital Trust Co.	1985	x		x	x			x
Continental Trust Co.	1985	x					x	x
Provincially chartered trust and loan companies								
Greymac Trust Co.	1983	x	x	x			x	
Seaway Trust Co.	1983	x	x	x			x	
Crown Trust Co.	1983	x	x	x			x	
London Loan Co.	1985	x					x	
General insurance companies								
Pitts General Insurance Co.	1981				x	x		x
Strathcona General Insurance Co.	1981	x				x		
Cardinal Insurance Co.	1982	x	x			x		
Ideal Mutual Insurance Co.	1985	x						
Northumberland General Insurance Co.	1985	x	x					
Other institutions								
Argosy Financial Group of Canada	1980	x					x	

with substantial powers, these powers – most of which were designed for the financial system of the early postwar years – appeared, in many cases, to be inadequate to deal with the recent onslaught of financial difficulties. Moreover, the capacity of the regulators to spot impending financial crises and to take prompt action to forestall insolvency situations has come into question in recent years, with the difficulties mainly originating with enforcement procedures. Furthermore, according to the Office of the Inspector General of Banks in its submission to the Estey Commission, there was a problem of insufficient staff, particularly after the large increase in the number of chartered banks following the 1980 revisions to the *Bank Act*.

The turbulence of the past several years raises a number of other serious questions. Is it prudent to combine banking and insurance, or commercial lending and securities underwriting? Equally pressing is the question whether it is wise to permit financial and non-financial activities to be combined under one corporate roof – an issue forcefully highlighted during the debate concerning the takeover of Canada Trust by Imasco from Genstar. A related question involves the increased concentration of ownership that results from the takeover of previously independent financial institutions by conglomerates and holding groups. Yet another concern that arises in respect to such developments is the very real potential for abuses. This problem was sharply underscored in the early 1980s by the Crown/Greymac/Seaway Trusts affair, involving the "flipping" of more than 10,000 Metropolitan Toronto apartment units and the use of associated trust companies to finance the purchase, which resulted in a massive increase in their value for mortgage purposes.

Competition and Concentration

Despite legitimate concerns about the impact that financial holding groups may have on concentration in the future, the fact is that, to date, they have not yet had any significant effect on individual markets. On balance, competition in the financial industry has increased, and it is expected to continue to do so in the years ahead, although the level of concentration in some individual financial markets remains above average. In other words, a few firms dominate a relatively large share of the market.

Notwithstanding the trend noted above, the spread of competition in financial markets continues to be impeded by both legal and non-legal (mainly economic) barriers to the entry and exit of institutions. In some cases, the need for a branch system to serve the public at large imposes very heavy start-up costs. There are also various incorporation and licensing requirements at both the federal and provincial levels, capitalization requirements, and prohibitions imposed on institutions against operating in particular markets. A further impediment is the requirement that regulatory approval be obtained in some cases before winding down operations and surrendering a charter. The lack of harmonization of requirements between federal and provincial agencies has also served to impede the spread of competition in the marketplace.

Access

As for accessibility, a wide variety of financial services are available to most Canadians – an important criterion in judging the effectiveness of a financial system. Larger customers, of course, have available to them a greater range of financial instruments, enabling them to make use of more-diversified services. But it has long been recognized that many smaller businesses are confronted by financing problems because of the difficulty they experience in raising equity capital. Despite the general availability of financial services to most Canadians, the fact remains that, excluding insurance, more than 1,700 localities are served by only one pillar of the system (see Chapter 6 of *A Framework for Financial Regulation*). In many of these cases, a bank branch or a local financial cooperative is the only available point of sale. While the public in such communities can gain access to other institutions by telephone or letter, this is often an unsatisfactory substitute.

Our research suggests that efforts to improve the provision of relevant information to middle-income individuals and smaller firms, probably on a user-pay basis, would help them to manage their financial affairs better. Although problems may arise because of the growing diversification of services offered by financial institutions, it is also necessary to bear in mind that the restriction of such developments could reduce the availability of financial services in certain parts of the country.

The Uneven Financial Playing Field

Yet another problem that has emerged as a result of the breakdown of the division that once existed between the pillars of the financial system is the uneven application of regulations to the various players. Rather than striving to provide a "level

Industry Concentration in Selected Financial Markets in Canada, 1967, 1979, and 1984

		All mortgages	Personal and commercial loans	Deposits	Life insurance (direct insurance in force in Canada)		Securities (common stock issues, excluding private placements)
					Ordinary	Group	
Share of the four largest companies in total activities (per cent)	1967	28.3	..	..	..	..	..
	1979	28.7	72.2	57.5	..	..	..
	1984	29.1	65.4	51.2	28.4	39.6	63.2
Number of companies needed to account for 80 per cent of the market[1]	1967	26	..	..	..	..	..
	1979	26	5	9	..	..	..
	1984	24	7	12	30	20	8

.. not available.

1 In a study by the Department of Consumer and Corporate Affairs, the degree of concentration is determined by the number of companies that account for 80 per cent of the output or employment of an industry. The degree of concentration is very high when that number is 4 or fewer; high, with 5 to 8 companies; relatively high, with 9 to 20 companies; relatively low, with 21 to 50 companies; and low, with more than 50 companies.

SOURCE Chapter 3 of *A Framework for Financial Regulation*. Different measures of concentration were developed in that chapter, depending on the kind of ownership links between institutions and the kind of activities (domestic; worldwide; or estate, trust, and, agency business) taken into consideration.

Major Regulatory Differences Affecting Different Categories of Financial Institutions in Canada

	Banks	Credit unions and caisses populaires	Trust companies	Loan companies	Life insurance companies	General insurance companies	Securities dealers
Deposits	Allowed	Allowed	Allowed	Allowed	Can provide only deposit-like short-term deferred annuities	Not allowed	Deposit accepted in form of cash-management accounts
Statutory reserves							
Primary (non-interest-bearing)	10 per cent on demand deposits 2 per cent on notice deposits up to $500 million 3 per cent on notice deposits over $500 million 3 per cent on foreign-currency deposits of Canadian residents	Not required	Not required	Not required	Not required	Not applicable	Not required
Secondary	Required, as set by Bank of Canada	Not required	Not required	Not required	Not required	Not applicable	Not required
Deposit insurance	CDIC coverage	Covered by RADQ in Quebec; OSDIC in Ontario; protected by stabilization funds in other provinces	CDIC coverage, except RADQ for provincial companies in Quebec; some companies not covered	CDIC coverage, except RADQ for provincial companies in Quebec; some companies not covered	None	Not applicable	Industry contingency fund
Mortgage lending	Allowed	Allowed	Allowed	Allowed	Allowed	Allowed	Allowed
Commercial lending	Allowed	Allowed	Restricted to inclusion in basket (varies, depending on incorporation)	Restricted to inclusion in basket (varies, depending on incorporation)	Not allowed	Not allowed	Not allowed
Personal lending	Allowed	Allowed	Restricted to inclusion in basket (varies, depending on incorporation)	Restricted to inclusion in basket (varies, depending on incorporation)	Can only offer policy loans	Not allowed	Can extend credit on margin accounts

	Banks	Credit unions and caisses populaires	Trust companies	Loan companies	Life insurance companies	General insurance companies	Securities dealers
Corporate securities underwriting	Not allowed	Not allowed	Not allowed	Not allowed	Not allowed	Not allowed	Allowed
Securities distribution	Allowed, but cannot advertise outside branch or solicit business	Allowed	Allowed	Not allowed	Not allowed	Not allowed	Allowed
Investment counselling	Not allowed	Not allowed	Allowed	Not allowed	Allowed	Allowed	Allowed
Portfolio management	Restricted to non-discretionary funds	Not allowed	Allowed	Restricted to acting as agency	Allowed	Allowed	Allowed
Trustee services	Not allowed	Not allowed	Allowed	Not allowed	Not allowed, except for provincial incorporated companies in Quebec	Not allowed, except for provincial incorporated companies in Quebec	Not allowed

playing field," the regulatory system imposes different costs and restraints on any one of a number of particular activities, the difference depending on the type of institution involved. A level playing field would require that all the institutions engaged in similar activities be subject to the same rules. For example, all institutions involved in the acceptance of deposits would be required to meet the same requirements with respect to the holding of reserves. Today, institutions in a number of different pillars accept deposits (however described), but only the chartered banks are required by statute to hold non-interest-bearing reserves against those deposits. On the other hand, while trust companies are not obliged to hold such reserves, they face limits on the amount of personal and commercial lending that they can undertake; and unless they qualify as a direct clearer with the Canadian Payments Association, they cannot turn to the Bank of Canada as a lender of last resort to help surmount short-term liquidity problems. Quite apart from its lack of fairness, the absence of a level playing field tends to reduce the competitiveness and effectiveness of the financial system.

Divided Jurisdiction

As we pointed out earlier, jurisdiction over financial institutions has always been divided between the federal and provincial governments. It has become an increasingly serious problem, as the financial system has become more complex and the lines between the different financial sectors have blurred considerably.

Depending on the institution involved, identical or very similar functions may be regulated at either the federal or provincial level – and by more than one agency at each level (see Chapter 2 of *A Framework for Financial Regulation*). For example, deposit-taking, which is a central element of the financial system, is subject to regulation by the federal Inspector General of Banks, the federal Department of Insurance, the Canada Deposit Insurance Corporation, various provincial regulatory agencies, and, where applicable, by the Régie d'assurance-dépôts du Québec. The share of banking activity that is regulated under the *Bank Act* has declined significantly. Between 1967 and 1985, for example, the share of total deposits held in chartered banks – as opposed to other financial institutions – declined from 75 to 64 per cent. There has also been an increase in the extent to which financial activities generally are regulated by provincial rather than federal authorities.

The problems growing out of this division of jurisdiction and the growing complexity of the system have been compounded by the lack of harmonization of provincial policies and practices. Indeed, there have been instances when they have appeared to pursue

quite different approaches. Within recent times, Quebec moved to open up its approach to insurance by allowing institutions to engage in almost any activity. In revising trust company legislation, however, Ontario decided to permit only a modest extension of previously existing powers. Furthermore, there was a period in the mid-1970s when the two provinces were engaged in direct competition involving the location of securities transactions, as a result of directives issued by their respective securities commissions.

What Kind of Regulatory System?

A Key Issue

From our examination of all of the developments of the past two decades or more, a key issue that emerges for consideration, in our judgment, is whether the basic objectives for regulating the financial system are being adequately met in the very different circumstances that prevail today, both at home and abroad. Given a system in which the functions performed by the pillars were quite separate and distinct, "regulation by institution" made good sense. As we have seen, however, the distinction between the pillars has become increasingly blurred, in no small measure because of the concerted efforts of many institutions to infiltrate another pillar in an attempt to preserve or expand the size of their operations.

The problem caused by maintaining the demarcation lines between the various pillars has been compounded by the development of a vast array of new financial instruments that do not fit easily into traditional categories, which in turn adds to the difficulty of distinguishing between institutions according to the composition of their liabilities. What, for example, is the difference between short-term deferred annuities offered by life insurance companies and the term deposits offered by banks and trust companies? What is the difference between the cash-management account offered by an investment dealer, on which cheques may be drawn, and a bank deposit?

One alternative to regulation by institution is "regulation by function." Under this approach, each different type of financial function, be it banking or insurance, would be subjected to regulation. This approach would have the advantage of making it possible to establish a level playing field for all of the participants. It would also make possible an increase in the diversity of services available from competing institutions, which is something to be welcomed from the consumer's point of view. By itself, however, this approach poses a potentially serious problem because it makes it difficult to regulate and monitor for solvency, since solvency relates to an institution as a whole rather than its separate activities. From that perspective, regulation by institution continues to have an advantage.

While there are undoubtedly differences of opinion about the form that regulation of financial institutions should take, on one fundamental point there is a very broad and strong consensus: the current regulatory system, at both the federal and provincial levels, is urgently in need of fundamental reform. That this is the case is clearly evident from the conclusions of several federal and provincial studies of recent years (see below).

In considering alternative means of reforming the present system, it is important to bear in mind certain basic objectives. In our view, it is essential to seek a balance that will reconcile inherent conflicts that may arise in seeking to achieve such objectives as competition, institutional solvency, the availability of financial services and information to the consumer, and consumer protection. At the same time, it is also essential to take account of other important factors that must be weighed in the balance. These include technology, current institutional practices, the nature of existing financial instruments, consumer sophistication, the mobility of capital, and the domestic and international economic environment.

Other Current Studies of the Financial System

As pointed out in the Foreword, our research for this report led us to examine a number of studies of various aspects of the financial system that have been published over the past 18 months. All of these reports have made an important contribution to the understanding of many of the issues at hand. Quite naturally, they tended to focus on issues that were prominent when they were written or that were directly related to their more specific area of concern. As a result, many of these studies understandably did not pay equal attention to such broad objectives as improving competition, improving solvency, and expanding consumer access and protection. Consequently, depending on the report and on the issues, a different vision emerges as to how the financial system should be regulated in the coming decades (see Appendix).

In the spring of 1985, a Green Paper was released by the federal government. This document proposed for consideration a number of changes in the system, in response to the apparent inability of current regulations to deal with the increasing importance of holding groups, the increased competitive pressure among the various pillars to diversify their operations, and the accompanying developments involving abuses of conflict-of-interest situations and self-dealing.

The Green Paper was followed by a federal task force study, known as the Wyman Report, which was undertaken in response to the rising deficit of the Canada Deposit Insurance Corporation that resulted from the failures of a number of trust companies. The task force had been charged with the responsibility of recommending possible reforms to, and methods of funding for, deposit insurance.

An examination of these two reports was subsequently undertaken by the House of Commons Standing Committee on Finance, Trade and Economic Affairs. The committee's conclusions were published in November 1985 and have come to be referred to as the Blenkarn Report. As this report came in the wake of the failures of the Canadian Commercial Bank and the Northland Bank, it focused mainly on issues of solvency and consumer protection. The first of two reports by the Senate Committee on Banking, Trade and Commerce, released in December 1985, was a response to the Wyman Report. The second report, which was in response to the Green Paper, was published in May 1986.

In February 1985, the Ontario Securities Commission published a report in response to recent developments in the securities markets. In December of that year, the Ontario Government released the final report of its Task Force on Financial Institutions, commonly known as the Dupré Report. It was prompted in part by the 1983 failures of three Ontario trust companies, which dramatically brought home the need to review legislation governing financial institutions.

At the time of writing, still to come is the report of the Commission of Enquiry on Certain Banking Operations, presided over by the Honourable Mr. Justice Estey. The commission's report deals with the circumstances surrounding the failure of the Canadian Commercial Bank and the Northland Bank.

Alternative Models for Financial Regulation

At one time or another, various comprehensive models for regulating a financial system have been put in place or have been proposed. These models can be differentiated by four characteristics: the type of regulation (regulation by function vs. regulation by institution, or separate regulatory authorities covering each type of institution vs. a super-regulatory structure); the approach to ownership of financial institutions (separate ownership vs. cross-ownership); the extent of involvement of institutions in different functions; and the relationship between the capital base that an institution is required to maintain and the function it is authorized to perform.

The *original pillar* system was based on separate regulation and separate ownership of broad categories of financial institutions. It was basically a regulation-by-institution approach. Because the activities of most institutions in the early 1950s were restricted to a primary function, regulation by institution also amounted *de facto* to regulation by function. That this outcome was more by accident than by design was evident from the subsequent extension of powers granted to various categories of institutions, which often allowed them to engage in activities outside their original function. For instance, the move of trust companies into the short-term deposit market in the late 1960s enabled them to become more involved in banking.

An often-proposed alternative is to provide a *limited extension of powers* for various groups of institutions, with or without maintaining a separate regulatory structure. Ontario's Dupré Report, for example, favoured enhancement of the investment powers of various groups of institutions but suggested that cross-pillar diversification be realized only through a financial holding group. The Blenkarn Report and the Senate Committee Report recommended an expansion of investment powers of financial institutions by any means – in-house, or through subsidiaries or upstream and downstream holding companies. The House Committee would also change the regulatory structure, however, while the Senate Committee would maintain the existing regulatory framework of a single regulator governing each type of institution. The framework recommended by the Senate Committee Report remains, in its concept, close to the current pillar system, providing as it does for a separate regulatory authority for each broad category of institution, and also for separate ownership. Some cross-ownership would be allowed, however, either through subsidiaries or through holding companies.

One problem with the extension-of-powers approach is that it only takes into consideration the current needs and wishes of financial institutions. For instance, extending commercial lending powers to a maximum of 20 per cent of assets for trust and life insurance companies, as suggested in the Senate Committee Report, may be quite satisfactory today but quite constraining a few years from now. Nor does such a model address the issue of the jurisdictional overlap or inconsistencies, or the lack of harmonization between the various regulatory authorities. In fact, the enlargement of institutional powers and of the range of permissible activities is likely to proceed at a different pace under different jurisdictions. Moreover, different regulators may have different views of what is prudent for an institution to do, which could result in increased differences between institutions. In these circumstances, it might become more difficult to achieve a level playing field, and the regulatory balkanization of

Models of Organization of the Financial System in Canada

	Original pillar system	Current pillar system	Limited extension of powers with or without subsidiaries	Consolidation of regulatory structure	Universal powers	Multifunction institutions	One function – one institution
Approach to regulation	One regulator for each category of institution: regulation by institution	One regulator for each category of institution: regulation by institution	One regulator for each category of institution: regulation by institution	One super-regulatory body: regulation by institution	One regulator for each category of institution: regulation by institution	Separate regulator for each main function: regulation by function	Separate regulator for each main function: regulation by function
Ownership structure	Distinct, by institution	Distinct, by institution	Distinct, by institution; some cross-ownership through subsidiaries or holding company	Distinct, by institution; some cross-ownership through subsidiaries or holding company	One ownership for all functions	One ownership for all functions	Cross-ownership through holding company
Institutional involvement in different functions	Restricted to main function	Generally limited to original main function	Cross-function inroads, as allowed by law	Generally limited to original main function	Unlimited	Unlimited	Restricted to one function
Capital base	One capital base for each institution; one base supporting one main function	One capital base for each institution; same base possibly supporting several functions; possibility of pyramiding	One capital base for each institution; same base possibly supporting several functions; pyramiding controlled	One capital base for each institution; same base possibly supporting several functions; pyramiding controlled	One capital base	Separate capital base for each function through bookkeeping exercise	One capital base for each institution; no pyramiding
Models	Canada in the 1950s and 1960s	Status quo	Senate Report	To different degrees: Green Paper and Blenkarn Report	West German and French models	ECC 1976 Report	ECC 1986 Report

the financial system could increase. The scope for diversification would appear to be limited, and the standards established to ensure solvency and the absence of various abuses would vary, as they do today, between different jurisdictions. Furthermore, regulators might lack the expertise required to supervise activities that fall outside the function for which they were originally responsible. In this context, the Senate Committee Report notes that the trust company regulators should have little difficulty supervising commercial lending or deposit-taking activities, in which such institutions have been involved for many years. But it stresses that the Inspector General of Banks has no experience in supervising trust activities, which should militate against giving banks trustee powers. Allowing groups of institutions to diversify according to the perceived expertise of their regulator would take the system further away from a level playing field. Finally, there is the further problem that the same capital base would be supporting different activities and different functions.

In contrast to such an approach, the achievement of diversification through the establishment of subsidiaries, each being involved in separate functions – another alternative put forward by the Senate Committee and Blenkarn Reports – would help to maintain a separate capital base and a separate regulatory authority. It would not, however, insulate the parent company from the financial difficulties experienced by its subsidiaries, thus creating problems in ensuring confidence in the continuing soundness of financial institutions. Diversification through a holding group – an alternative considered in most reports – would provide better insulatior.. The complete ban on all non-arm's-length transactions that would be imposed by the Green

Paper would, however, negate most of the benefits to be gained from diversification.

To deal with the current harmonization problems within a regulation-by-institution approach, *consolidation of various regulatory authorities* has been proposed. The Green Paper would combine various federal regulatory authorities and would bring some financial holding companies under federal jurisdiction. The Blenkarn Report recommended the establishment of a super-regulatory agency that would bring together federal and provincial authorities, as well as industry representatives. The super-regulatory agency would also assume the management of deposit insurance and of other compensation funds. While the harmonization problem would be addressed, the scope for diversification and for a level playing field would appear likely to remain uneven in view of the fact that regulation by institution would give different powers to, and confer different obligations on, different groups of financial institutions.

A second alternative would be to provide for full diversification, which would result in the creation of *financial institutions with universal powers*; this is in line with the so-called West German or French models. This approach could lead, in the longer run, to increased concentration and reduced competition and accessibility, as institutions would compete for the total business of an individual rather than for some specific portion of it. (In West Germany, for example, banks with "universal powers" have been a factor in the slower development of equity markets.) Furthermore, the regulator responsible for an institution would have to regulate all of its activities. As a result, there would likely be uneven regulation of the same function among different kinds of institutions falling under different legislations, particularly since different regulators would have their own views as to how regulation should be applied. Some functions could be badly supervised in some institutions because of a lack of expertise on the part of the regulators. Abuses of conflict-of-interest situations would be more difficult to control, as they could be more easily hidden within the larger institutions. Nor would this approach provide adequate scope for a level playing field or for ensuring solvency.

Henry Kaufman, a noted Wall Street analyst, recognized these difficulties in a 1985 article in *The New York Times*:

> At the extreme, there will be institutions that would be lenders, equity investors and underwriters. It is very difficult to manage successfully the simultaneous performance of these functions. There are bound to be compromises within an institution that will deal inequitably with the creditor or equity position. . . . The financial system would look more like a zoo with the bars let down, with all of the attendant adverse consequences. In financial life, as in personal life, each of us cannot perform all roles best. The responsibility of each is different, and so it is with the trust and responsibilities embodied in a credit relationship.

Another difficulty is that the same capital base would be supporting different functions, thus increasing the risk of insolvency of the institution.

A third, broad alternative is the implementation of regulation by function in the context of a well-diversified institution performing different functions – the *multifunction institution*. This model is, to some extent, similar to what the Council recommended in its 1976 report on deposit-taking institutions. As each function would be regulated by its own expert authority, such a model would contribute to a level playing field. Although a separate capital base could be established by a bookkeeping exercise, however, we have come to the conclusion that this approach would not be fully satisfactory from the point of view of solvency and consumer confidence. If one function of a conglomerate faced financial problems, customers might have a legal recourse against the rest of the conglomerate. And even in the event of only limited recourse, there might remain a problem with confidence if one operating division were in difficulty. It would also be more difficult for the regulators to monitor bookkeeping entries within a large conglomerate, particularly as far as internal movements of funds are concerned. Furthermore, the supervision of the diversified institution would become a true nightmare, with continuous requests from different authorities, a great deal of overlapping, and no one having ultimate responsibility for the solvency of the institution.

Quebec's Bill C-75, which opened up various financial activities to the insurance industry, recognized the difficulties involved in regulating different functions within a single institutional framework. In his appearance as a witness at the hearings of the House of Commons Standing Committee on Finance, Trade and Economic Affairs, Jacques Parizeau, a former Quebec Finance Minister and author of the Bill, testified that "there is a provision in Bill C-75 that has not been noticed all that much (Section 33.3). It implies that as an insurance company diversifies its operations the Minister can require that whenever operations other than insurance represent more than 2 per cent of total revenue of that insurance company a subsidiary must be set up. In other words, the main thrust here is that for purposes of inspection we should not allow operations to diversify without subsidiaries being set up." Another difficulty that was brought up at the committee hearings – and the reason for keeping major functions separate in distinct institutions – is the different accounting practices that make it almost impossible to provide consolidated statements.

In short, while the "extension of powers, with or without a consolidation of regulatory structure," the "institutions with universal powers," and the "multifunction institutions" models for the organization of the financial system would increase, to different degrees, the scope for a level playing field, for confidence, and for access, they would also have shortcomings – some of them more serious than others.

After due consideration of the alternatives, we have opted for a major overhaul of the regulatory system, but within a different organizational structure than any of those outlined above. We are convinced that the weaknesses of the present regulatory system are so severe that fundamental reform has become imperative.

A New Framework for the 1990s: One Function – One Institution

In order to maintain world-class financial institutions in Canada and to serve all Canadians well – be they individuals or businesses, be they of considerable worth or of more limited means, and independently of their location – there is a need to strike the best balance, through regulatory reform, between enhanced competitive flexibility, strengthened institutional solvency and public confidence, and adequate consumer protection and accessibility. In doing so, the cost of regulation should be minimized – that is, its cost in terms of administration and also in terms of disruption of, and interference with, the normal course of business of financial institutions. Furthermore, there is a need to be forward-looking and to encourage flexibility, so that the fast pace of change will not render the revised regulatory framework antiquated in a few years' time. Historically, the managers and directors of financial institutions and government regulators have shared the responsibility for supervising the conduct of financial business. We believe that the new framework should continue to be based on a system of checks and balances between the managers of financial institutions and the regulators. This will call for improvement both in direct government regulation and corporate governance.

In line with these principles and given the importance of guaranteeing a level playing field, we first reaffirm the position taken 10 years ago in our report on deposit-taking institutions:

1 **We recommend that governments adopt a regulation-by-function approach to the reform of the Canadian financial system.**

But we also opt for a specific form of regulation by function (a departure from our 1976 report) that would go a long way towards achieving a balance between regulating for competition and regulating for solvency:

2 **We recommend that each financial institution be limited to the performance of a single major function, falling under a single regulatory authority, such as banking, securities underwriting and trading, life insurance, and property and casualty insurance.**

Under this "one-function/one-institution" approach, each institution performing a single major function would fall under its own separate regulatory authority. That authority would regulate the various aspects of the function and would at the same time regulate for the solvency of the institution. A function is in large part defined in terms of the liabilities of the financial institution. (A more precise definition can be found in the glossary.) The functions would be specified in various governing legislations. The operations of an institution would be limited to activities associated with a single function – a rule that would oblige a few institutions to spin off some activities to related institutions. Diversification across functions would be allowed through cross-ownership, as indicated in Recommendation 5 below. Although the recent internationalization of financial markets and the development of technology have facilitated the prudent mixing of various assets and liabilities, the performance of major functions still calls for different techniques and involves separate markets. For instance, the insurance industry deals, on its liability side, with different risks and uses different techniques than other financial sectors. A distinction could even be made between life and casualty insurance, as they each deal with different categories of risks. The securities-underwriting-and-trading function uses specific techniques and involves distinct markets, as do deposit taking and the maintenance of a payments system. Banking, securities underwriting and trading, and casualty and life insurance are undoubtedly major functions that warrant a separate regulatory authority. We recognize that estate, trust, and agency (ETA) business could be viewed as an "activity," falling under Recommendation 4 below, or as a function. If viewed as the former, the regulator would have to determine if this activity could be "prudently" mixed with banking, securities dealing, or any other function. Because of the potentially serious situations of conflict of interest that could arise in such mixing, ETA business would most likely end up on its own, as a separate function. Of course, the above-mentioned list is not meant to be exhaustive, and other candidates for "functions" may be considered.

A one-function/one-institution approach requires that the major functions be well defined. This is already the case for life and casualty insurance, and for securities underwriting and trading, which cur-

rently operate under distinct regulatory authorities. But one of the enduring shortcomings of the Canadian regulatory framework has been its inability to provide a definition of a bank and of banking business.

3 We recommend that any institution involved in the provision of a means of payment be considered a bank and be considered as operating under the *Bank Act*, with the understanding that the Act will be amended to recognize the special characteristics of the credit unions and caisses populaires.

This is a forward-looking definition of banking, flexible enough to remain relevant for years to come. Indeed, it is based on the broad concept of "means of payment" – that is, any instrument widely accepted in payments for goods and services and for discharge of debt. Any institution that accepts deposits – the main means of payment today – would be considered a bank. In the future, should the securitization process continue and should units in securities pools become a means of payment, institutions that provide such units would then fall under the *Bank Act*. The provision of a means of payment has to be distinguished from the extension of credit to facilitate the purchase of goods and services. Credit cards fall in the latter category. Point-of-sale terminals are a means of transferring deposits, and the rules governing such transfers should be established by the banking system. This is the position of the Canadian Payments Association, as spelled out in a recent statement.

This recommendation would cause all deposit-taking institutions, such as credit unions and loan and trust companies, to be subjected, in one form or another, to the *Bank Act*. Investment dealers would have to reconsider the nature of cash-management accounts, and life insurance companies might have to review the structure of their short-term deferred annuities. This is different from the approach adopted in the Green Paper and in the House and Senate Committee Reports, which would allow for the banking function to be performed by non-bank institutions. That institutions not currently operating under the *Bank Act* have been able to participate in the provision of the means of payment has been the result of historical developments, at both the federal and provincial levels, and has constituted a departure from the original constitutional agreement. Several Supreme Court decisions have confirmed, over the years, that banking falls under federal jurisdiction, and they have interpreted banking as providing the means of payment. As discussed in greater detail later on, this approach does not necessarily lead to greater centralization of the regulatory apparatus.

Special consideration would have to be given to financial cooperatives – the caisses populaires and credit unions. One possible approach would be to create, under the *Bank Act*, a specific category called "cooperative banks." Such a category already exists in some countries (West Germany, for example). Arrangements could be such that the centrals would fall under the banking regulatory authority, while the locals would retain their autonomy. Reserves would be managed, and leverage monitored, at the provincial level through the central organizations, although reserves would be calculated on the basis of deposits in all locals. Already, membership of financial cooperatives in the Canadian Payments Association is mainly realized through the centrals.

The next step is to define the activities that are permissible for each major function.

4 We recommend that the range of permissible activities and investment powers of financial institutions be determined by what is considered prudent for each function.

This is a question of matching assets and liabilities, and techniques of operation, with specific functions. For instance, commercial lending may not be an appropriate activity for securities firms, given the different techniques involved and the potential for conflict of interest. With the development of technology and with financial innovation, the concept of what constitute prudent activities for one function may well change over time. The responsibility of determining what is or is not prudent for a one-function institution should be shared between management and the regulator responsible for the function performed by the institution. In participating in this decision-making process, the regulator should remain on top of a continuously changing financial world and should show appropriate flexibility in adapting to new situations. Furthermore, a clear distinction should be maintained between the concept of "activity" and the concept of "function." In particular, the determining of what constitutes a "prudent activity" should not be the occasion to mix different functions within one institution.

In a one-function/one-institution environment, cross-function diversification could be effected through cross-ownership of financial institutions.

5 We recommend that diversification into any function be allowed only through a financial holding group that would bring together distinct corporate entities performing different major functions. Institutions that are members of a holding group should be allowed, within limits set by the relevant regulator, to sell assets and to lend funds to one another without any prior regulatory approval, except when one member has been identified as facing financial difficulty. Institutions with activities that remain within a major function should not be required to join financial holding groups.

Full diversification would be permitted, as any institution would be able to belong to a holding group. The movement of funds between the members of a holding group would be crucial in that it would be a key to the process of diversification and would enable institutions to take advantage of profit opportunities in different areas that such a process would entail. On the other hand, the one-function/one-institution framework would be aimed at keeping a clear separation between major functions so as to simplify the supervisory process and to minimize potential abuses. Such a separation would make it easier for the regulator to identify and follow transfers of funds. But to strengthen control over possible abuses, a limit should be placed upon such movements. While the easiest route would be to impose a limit of, say, 10 per cent of outstanding equity on the total amount of funds outstanding that an institution can have invested in, or loaned to, other members of the holding group, it should be recognized that different ways of moving funds have different impacts. For instance, the sale of assets between two member institutions of a holding group should be distinguished from a loan. The latter would involve the creation of a cross-liability within the group, whose true market value might be more difficult to assess than that of an external asset. Different limits could thus be imposed, depending on the avenue used to reallocate funds within a holding group. In any event, guarantees given by one institution to another member of a holding group should be prohibited. These are off-balance-sheet items, whose monitoring by the supervisory authority often turns out to be problematic. Furthermore, the value of the contingent liability involved in such guarantees is difficult to assess.

Member institutions of a holding group should not be allowed to invest in the equity of other members. Equity injections would only come from the holding company itself (the major shareholder in the institution) or from minority shareholders. This would strengthen the one-function/one-institution framework and help to prevent the pyramiding of the capital base.

Funds could thus be reallocated within a holding group through some limited cross-lending and cross-selling of assets and through the movements of dividends and equity investments between the holding company and its subsidiaries. While one of the strengths of a holding group is its ability to come to the aid of a member in financial difficulty, one has to ensure that such action does not endanger the safety of other members or that funds are not unduly moved out of the troubled institution. Prior approval to move funds within a holding group would automatically be needed when the relevant regulator has established, on the basis of objective solvency tests, that a member institution is facing serious financial difficulty and has placed it on a special "watch list" and informed other regulators. This assumes, of course, that monitoring for solvency has been strengthened and that an effective early-warning system has been put in place. It also assumes that the regulatory authority would become aware of the existence of serious financial difficulties that could endanger the continued solvency of the firm at an early stage and that the regulator's decision on the request to transfer funds would be given promptly. We appreciate that this would require a large degree of collaboration between regulators, auditors, and management. Furthermore, because such an approach might appear to increase the regulatory burden on the institutions involved, an alternative to securing prior approval would be a full disclosure of non-arm's-length transactions. In particular, the need to secure prior approval could be seen as involvement of the regulatory authority in management decisions. A problem with disclosure, however, is that in order for it to be effective, regulators should be given the power to reverse the transactions that they deem to be harmful. But even if regulators had the power to make and enforce such requests, this type of action could be quite disruptive to the institution involved. Thus disclosure may not be an appropriate alternative to prior approval for all types of institutions. The holding company should preferably be inactive, and the holding group would not require any special form of regulation. The holding group should, however, be monitored for its overall solvency.

6 We recommend that regulatory authorities take special measures to monitor the financial health of financial holding groups.

To this effect, the holding company would be required to supply, on behalf of the group, global financial statements to the regulator of each member of the group. Quarterly audited statements, although preferable, might be quite costly. Financial holding groups would, under this approach, provide quarterly financial statements, but only the annual ones would be audited. We also recognize that accounting methods differ between different categories of institutions, thus making it impossible in certain cases to provide true consolidated statements. Until harmonization in accounting practices is achieved, holding groups should submit statements that reflect, as closely as possible, the global position of the group.

While a one-function/one-institution structure would be maintained at the "production" level of financial services, retail outlets or points of sale must be able to offer a variety of financial services originating from different institutions. This would ensure access to a variety of financial services in many areas of the country that are served by only one or a few financial institutions. Consequently,

7 We recommend that all forms of networking, cross-selling, and cross-referral within the financial system be allowed. Tied-selling should, however, be prohibited.

The Benefits of the Proposed Changes

The implementation of the above seven recommendations would undoubtedly necessitate important changes in the organization of the Canadian financial system at both the production and the delivery level. A one-function/one-institution environment would be quite different from the existing pillar system, because a specific function would become the primary target of regulation. It would keep a separate regulatory authority for separate categories of institutions – a feature of the existing pillar system. But it would depart from the current separate-ownership approach, as cross-ownership would be allowed through the establishment of holding groups – a route necessitated by the need to maintain a separate regulatory structure for each category of institution. (It is important to note that the one-function/one-institution approach would deal with the production level of financial services; any retail outlet would be able to distribute any product offered by any category of institution.)

The primary advantage of this new configuration of the financial system is its simplicity. Regulators would only have to worry about one function. As they would only monitor activities in which they have expertise, they would be in a position to do a better job. In addition, there would be only one regulator per function. This would be an advantage over the extension-of-powers and super-regulatory approaches. Agents performing the same function would fall under the same regulation and would benefit from a level playing field; a separate capital base would support each major function – again, an improvement over the extension-of-powers and the institutions-with-universal-powers approaches. Furthermore, by prohibiting the pyramiding of capital and lateral interdirectorships, whereby the same directors are on the boards of two or more members of a holding group, the separation between major functions would be strengthened. (The prohibition of such interdirectorships would open the door for outside directors – individuals not associated as officers or directors, nor affiliated with major shareholders of the family of companies – who would be able to sit on special committees of the board as required by Recommendations 14 and 15 below. But this would not preclude the holding company from having representatives on the board of its subsidiaries.) In the one-function/one-institution model, the concerns with the promotion of competition and the maintenance of solvency and confidence would thus be simultaneously addressed. Accessibility would be enhanced by allowing retail outlets to distribute any financial product.

Second, this new configuration would offer individual financial institutions great flexibility in meeting the various financial requirements of their clients. Diversification into any area would be open to any institution through the holding-company route. Banks would be allowed to participate in such organizations, as would credit unions, life and general insurance companies, and investment dealers. This holding-company approach is, to some extent, similar to the framework that emerges from the Green Paper and the Dupré Report. Diversification loses its attractiveness, however, if funds cannot be reallocated within an organization in order to benefit from the best opportunities. In contrast with the position taken in the Green Paper, our framework would provide for flexibility in moving funds, within certain limits, between members of a financial holding group, except when an affiliate is facing financial difficulty, at which time approval by the regulatory authority must be sought. That certain transactions should be prevented from occurring in the presence of financial difficulties does not justify stifling the operations of a healthy holding group by imposing a complete ban on non-arm's-length transactions. Other measures discussed later on are aimed at preventing the abuses of conflicts of interest and self-deals that may arise in the context of movements of funds between the affiliates of a holding group.

Furthermore, our approach provides for a great deal of flexibility in the way that a holding company operates. Diversification might only take place at the production level, with various products distributed by distinct sales networks; for instance, life insurance salesmen might only sell life insurance policies, while mutual funds might be distributed by financial planners. On the other hand, distribution might take the form of a financial supermarket or a one-stop financial centre.

One-stop shopping would not necessarily be tied to a holding-group structure, as any institution would be able to enter networking agreements. Firms that wanted to remain specialized could do so, as the requirement to operate under a financial-holding umbrella would only apply to an institution that wished to perform more than one of the defined major functions.

This approach also recognizes the special characteristics of certain groups of institutions and provides for their integration into the global framework, while preserving their respective identities. Particularly, the framework recognizes the important role played by financial cooperatives in providing access to financial services from coast to coast.

The framework is also forward-looking in the sense that it does not cast in stone the existing organization

of the financial system. The definition of major functions could be changed over time, if warranted. We have also pointed out that the notion of "prudent activity" is in constant evolution – a fact that should be recognized by the regulatory authority. Our proposed definition of banking has to do with the nature of the means of payment and not with deposit-taking activities per se or the conjunction of deposit-taking activities and lending activities.

These are benefits that we believe to be substantial. They outweigh the costs of changing the existing regulatory framework and the organization and practices of institutions.

Costs

The implementation of the proposed package would require some changes in the current regulatory structure, particularly with respect to the sharing of responsibilities between the federal and provincial governments. Historically, the involvement of both levels of government has provided a system of checks and balances between matters of national interest and concerns of a regional nature. The problems with the existing regulatory framework do not rest on the fact that both levels of government have jurisdiction over financial activities but, rather, on a lack of clarity in the sharing of responsibilities and a lack of harmonization between various authorities. We firmly believe that the maintenance of a payments system and the safety of deposits are matters of national interest and that the regulation of the deposit-taking function should fall under federal jurisdiction. This would apply to the deposit-taking activities of trust companies, credit unions, and mortgage-loan companies.

It is less clear at what level other possible functions, such as life and general insurance or securities trading and dealing, to name but a few, should be regulated. The fact that financial markets are national (or even international) in scope does not necessarily require that they be centrally supervised at the federal level. It calls for intergovernmental cooperation and for some degree of uniformity among provinces. Furthermore, in bringing under federal supervision the provision of the means of payment, the special interest of provinces in specific areas should be recognized. In particular, provincial governments have historically been involved in the regulation of financial cooperatives. A happy medium should be found between the need to regulate the deposit-taking function at the national level, as a means of enforcing strict and uniform standards, and the more local nature of financial cooperatives. Our framework recognizes the special nature of financial cooperatives within the *Bank Act* and submits to this Act only the central organizations.

The maintenance of a payments system as a matter of national interest has been recognized by both the federal and provincial governments. The establishment in 1980 of the Canadian Payments Association under federal direction is an implicit recognition of federal jurisdiction in this matter. The CPA includes not only banks but also trust companies and financial cooperatives, many of which are provincially regulated.

While there are legal grounds for federal supervision of all banking activities, we recognize that the problems involved are more of a political nature. If it is to come about, the proposed realignment of regulatory responsibilities between the federal and provincial governments will need to be achieved through consultation and agreement. It must be the outcome of negotiations from which all parties involved would hope to benefit. Our approach does, therefore, require greater cooperation. In contrast with the proposals for federal supervision of holding companies or for the establishment of a super-regulatory agency, our recommendations do not involve greater centralization of the regulatory apparatus to any significant degree. For instance, local credit unions and caisses populaires would remain under provincial jurisdiction (some cooperative centrals already abide by many federal rules), and federally regulated trust companies already account for about two-thirds of all trust companies' assets in Canada.

The federal government might choose to delegate to a provincial government responsibility for the supervision of the banking institutions that operate only within the confines of that province. For instance, under such an arrangement, the government of Alberta could have responsibility over the Alberta Treasury Branches. This course of action – delegating federal regulatory powers to a province, for application and enforcement within that province – is akin to similar arrangements already adopted in other fields, such as transportation.

The reorganization needed within the institutions themselves appears much less formidable. For all practical purposes, major functions are already performed by distinct corporate entities. Some activities or services offered, such as brokers' cash-management accounts and life insurers' short-term deferred annuities, might have to be modified. The loss of such activities would be compensated by the diversification into banking activities that these companies could achieve by associating themselves with a bank through a holding company.

In their criticism of the Green Paper, the Blenkarn Report and the Senate Committee Reports note that there are costs involved in setting up holding companies. But these costs have not prevented the mushrooming of financial holding companies over the last few

years. The costs in the Green Paper proposals are to be found, instead, in the ban on any internal movement of funds.

Financial cooperatives and trust companies would be affected the most by the proposed changes. The obligation to hold non-interest-bearing reserves against deposits would impose some costs on these institutions. On the basis of 1984 figures and given the kind of deposits held by trust companies and local credit unions, it has been estimated that the net loss on the extra reserves required would be approximately $15 million for the trust companies and $14 million for the local credit unions, or about 5 per cent of their after-tax income. These figures take into account the fact that those institutions, particularly the caisses populaires and credit unions, already hold reserves, some of which are in the form of non-interest-bearing cash. Trust companies and credit unions could ease the cost of holding reserves by encouraging their depositors to shift funds from demand to notice accounts, thus lowering their reserve requirements. It should be noted that the imposition of reserve requirements would provide for a more level playing field for all deposit-taking institutions. And, as banks, these institutions would also gain access to the Bank of Canada as a lender of last resort. Furthermore, the cost of holding reserves could be significantly lessened if the Bank of Canada were to pay interest on them, as recommended in the Senate Committee Report. While this proposal may have merit, the Council has not investigated all aspects of this issue – including the impact on monetary policy – and therefore takes no position on this matter at this time.

In contrast, bringing the banking activities of financial cooperatives and trust companies under the *Bank Act* would not increase their tax burden. Currently, there are no significant differences in the taxation of trust companies and banks. Credit unions, which would come under the special cooperative-bank category, would be able to retain their current taxation status as long as locals remained small.

Finally, we have considered the cost of breaking up each existing trust company into two separate corporate entities, should the ETA business be deemed a separate function. It does not appear high, particularly since the breaking-up would only be required at the production level but not at the distribution level. Indeed, trust companies could continue to deliver, through their branch system, both banking and trust services. Most of their capital base would be assigned to the banking entity, as very little capital is needed to manage funds. The spawning of subsidiaries is nothing new in the financial industry. Because mortgage-loan companies are not subjected to reserve requirements, mortgage business has been shifted, particularly in recent years, from the banks to their mortgage subsidiaries. This transfer has taken place without pain and has not presented any significant problem at the delivery level. Mortgages are still handled by banks at the branch level, but they are registered in the books of the mortgage-loan subsidiary. The banks and their mortgage-loan subsidiaries conduct their business as separate corporate entities and fall under different regulatory authorities. While the establishment of subsidiaries is a common occurrence, the reorganization process should be such as not to affect unduly the value of the outstanding shares of a company. This should be a particular concern in the restructuring of existing trust companies.

Implementation

Because of the magnitude of the changes involved, institutions and regulators should be given time to adapt.

8 We recommend that the process of reorganizing the financial system allow sufficient time for institutions and regulators to adapt and that a set of target dates be established.

For example, institutions should be given enough time to modify some of their practices, to change their bookkeeping, to find partners when the need arises, and so on. Also, individual institutions should be given the opportunity to spread the cost of reorganization over several years. This should be the case particularly when institutions have to set aside non-interest-bearing funds to meet the newly imposed reserve requirements or if they have to separate some of their activities, as could be the case with existing trust companies. Time should also be provided for institutions to acquire the expertise needed to enter new areas. A free-for-all stampede into new activities should be avoided; indeed, it could result in a number of failures if institutions were to enter new areas unprepared. Finally, there should also be concern over the need to protect, at least during an interim period, the smaller institutions. There is the possibility that the larger institutions might be able to dominate new areas of activity and, in the process, hinder the development of the already-established smaller firms. This appears to be a major concern in Great Britain, where the securities industry is being deregulated. There are predictions that the majority of securities firms will disappear in the process and that a significant proportion of the business will go to non-British firms. In Canada, while opening up the Ontario securities industry to non-industry members, the government of Ontario has been careful to ensure that the process would be gradual, so as to protect from larger non-industry institutions those investment houses which might be an easy prey because of a generally weak capital base.

Furthermore, a large number of Acts would have to be amended to allow for the implementation of the new framework: these include the federal *Bank Act*, the *Canadian and British Insurance Companies Act*, the *Foreign Insurance Companies Act*, the *Trust Companies Act*, and the *Loan Companies Act*, as well as provincial legislation covering life insurance companies, trust companies, and credit unions, and provincial securities regulations, to name but a few. Time will be needed to proceed with such a busy legislative agenda. But there is urgency in getting the process of regulatory reform under way. Consequently,

9 We recommend that the federal and provincial governments amend all legislation of financial institutions as expeditiously as possible, with a view to implementing the one-function/one-institution approach.

Strengthening Regulatory Capacity

In the negotiations that would be undertaken between the federal and provincial governments to reorganize and streamline the regulatory process and to adapt it to the comprehensive organizational structure proposed in this report, the current division of power, with respect to the supervision of non-deposit-taking activities, would serve as a basis for the talks.

When all the dust has settled, an institution whose function falls under provincial responsibility might still have to deal with 10 different provincial authorities. In such an environment, cooperation and coordination among provinces, and significant consultation with the federal government, would be paramount. Provincial governments should formally cooperate in setting similar regulatory requirements for similar functions falling under their jurisdictional responsibility.

Harmonization does not mean that governments would lose their individuality or their capacity to innovate. But rather than introduce new legislation that would only take effect within a specific jurisdiction, changes would be proposed in an open forum, to be discussed and assessed by all governments.

10 We recommend that provincial governments put in place mechanisms to ensure interprovincial uniformity in the regulation of financial institutions and activities under provincial jurisdiction.

In our view, the approach recommended here would offer greater flexibility than some of the other proposals made recently, such as those favouring the federal supervision of holding groups or the creation of a super-regulatory agency. Indeed, there is no overwhelming reason for financial holding groups to be regulated – there is even less reason to do so at the federal level – and a super-regulatory agency could become unwieldy and too bureaucratic. The framework proposed here would keep separate regulators for separate major functions, each one supervising homogeneous institutions for which it would have developed the needed expertise. Harmonization would require greater cooperation between authorities. But there is much to be gained. The costs of supervision and inspection could be lowered for governments and for institutions through improved coordination.

Beyond the lack of well-defined jurisdictional responsibility and the lack of harmonization, dealt with in previous recommendations, another important shortcoming of the existing regulatory system has been the inadequacy of the powers held by regulators.

11 We recommend that the regulators of each type of financial institution be granted increased powers of surveillance and enforcement. We further recommend that any regulatory authority uncovering problems with a member company of a holding group alert the regulators of the other members of the group.

The Blenkarn, Dupré, and Senate Committee Reports have discussed at length the increased powers to be granted regulators. A summary of their recommendations – which we support – can be found in the Appendix. In this context, we wish to stress the need for increased powers to conduct detailed on-site inspections and for an authority to issue cease-and-desist orders.

Adequate regulation for solvency is of paramount importance. Many of the financial difficulties experienced by financial institutions in the 1980s have not been dealt with satisfactorily because of a breakdown in the regulatory process. The adequacy of a monitoring system to ensure solvency is crucial in our proposal for regulatory reform. In particular, regulatory authorities should be able to identify, at an early stage, institutions that are facing financial difficulties, particularly when they are members of a holding group. (In this sense, Recommendation 11 reinforces Recommendation 5.) Thus it is important that the federal and provincial governments take appropriate measures to put into place an adequate regulatory system for the solvency of financial institutions. Such a system should go beyond the simple analysis of financial statements. It should consider the composition of portfolios, the structure of liabilities, the risks assumed, and so on. More generally, it should be able to monitor institutions to ensure prudent behaviour. In particular,

12 We recommend that the development of an early-warning system with respect to the solvency of all financial institutions be encouraged so that preventive measures can be taken at an early stage.

Prudent Behaviour

Prudent behaviour entails:

- the management of credit risk, including asset quality and asset diversification across industries and regions of the country, as well as limits on the size of loans to any one customer;
- the management of funding risk – i.e., the maintenance of sufficiently stable sources of funds, such as retail deposits, for deposit-taking institutions and limited reliance on wholesale deposits;
- the matching of the term structure and liquidity of assets and liabilities;
- the maintenance of profitability;
- the maintenance of liquidity – i.e., the holding of sufficient liquid assets, so that any unanticipated cash requirements, such as withdrawal of deposits, can be met;
- capital adequacy – i.e., the maintenance of a capital base in relation to total assets that is large enough to cover any losses that might reasonably be expected to occur (the greater the riskiness of the asset portfolio, the greater the capital base should be);
- the management, or avoidance, of conflicts of interest;
- the avoidance of self-deals; and
- the avoidance of fraud.

This has been advocated by the Wyman, Senate Committee, and Dupré Reports. Such a system is currently in operation at the Office of the Inspector General of Banks and for some provincially regulated institutions. Such systems should be in place for all groups of institutions.

The supervisory authorities have the responsibility to keep abreast of developments in financial markets, so as to ensure that they do not threaten competition and solvency. When difficulties are looming on the horizon, authorities have a responsibility to intervene. Together, the streamlining of jurisdictional responsibility, particularly under the one-function/one-institution approach – which would enable the regulatory authority to devote its full expert attention to the supervision of one function – the defining of "prudent activities" attached to specific functions, and greater harmonization and cooperation between authorities, along with their enlarged powers, would enable regulators to be much more effective in maintaining a competitive and solvent financial system in Canada. It goes without saying that regulators should be given the appropriate means, in terms of staff and budget, to achieve this objective.

The supervisory authority should only have the responsibility of enforcing the law, however, and it should not implicitly modify it by "looking the other way." Changing rules and regulations is a prerogative of the Parliament of Canada and of provincial legislatures.

13 We recommend that all Acts and legislation governing financial institutions have sunset clauses and be subject to review at the same time.

This would, indeed, reduce the need for regulators to substitute themselves for the legislators. Furthermore, changes in an Act dealing with one group of institutions always have an impact on other groups. A simultaneous review of all Acts would make less likely a repetition of occurrences such as the one where revisions to the *Bank Act* granted banks the power to enter into the traditional areas of other institutions without considering amendments to the Acts governing those institutions (e.g., the entry of banks into the mortgage area). As the reforms proposed in this report involve the modification of all existing Acts, this could be the starting point for an orderly ongoing review process.

Prevention of Abuses; Ownership; and Consumer Protection

Conflicts of Interest and Self-Dealing

The cross-ownership structure implied by our proposed model could contribute to a larger number of

conflict-of-interest situations and could lead to more abuses. We have found that diversification can, indeed, lead to potential conflicts of interest and to self-deals. For example, within the trust business, conflicts of interest can arise when trustees are in a position to take advantage of the trust placed in them. Managers who have discretionary control over funds may leave large amounts in low-interest deposit accounts with their own firm (as Pittsburgh's Mellon Bank is alleged to have done with the uninvested cash balances of the State Public School Building Authority between 1966 and 1974). Or trustees may use trust funds to dispose of unwanted securities or to support their own lending activities. (Of the 50 larger companies in which Continental Illinois National Bank's trust department holds large equity investments, 75 per cent are commercial borrowers from the bank; there is, however, no indication that this potential conflict was abused in any way.) As trust companies increasingly enter the commercial-lending field, these types of conflict of interest take on increasing importance.

Conflict-of-interest situations can also arise when banking and securities dealing are combined within the same institution. A conflict could exist between the institution's deposit business and its stock-exchange transactions or between its stock-exchange transactions and its lending business. For example, it might be more advantageous for the institution to lend to a firm rather than assist it in the acquisition of new equity by underwriting an issue.

Abuses of conflict of interest, self-dealing, and fraud are a source of concern in all the other reports that we have surveyed. The Green Paper would prohibit all non-arm's-length transactions so as to minimize the risk of abuses. It also recommends the establishment of "Chinese Walls" and the creation of a Financial Conflict of Interest Office. The Blenkarn Report would provide the freedom to engage in non-arm's-length transactions, except those likely to have a significant impact on the institution's solvency. The Dupré Task Force would generally prohibit non-arm's-length transactions, with the exception of those whose true market value can be objectively ascertained by independent means. The Senate Committee Report recommends the implementation of a three-pronged procedure to control and review non-arm's-length transactions.

Earlier, we urged (Recommendation 5) that when one member of a holding group is identified by the regulator as experiencing financial difficulty, prior regulatory approval be necessary for moving funds between members of the group. But apart from this special case, we recognize that other constraints on the reallocation of funds within a conglomerate or holding group, intended to reduce abuses, would jeopardize the very benefits of diversification and conglomeration. At issue here is the difficult question of what is a transaction that enhances the efficiency of the production and delivery system of financial services and what is a harmful transaction. A distinction has to be made, as we have done throughout this document, between non-arm's-length transactions and self-deals. The former are transactions between two related parties, while the latter are harmful non-arm's-length transactions for the sole benefit of one of the parties involved. We do not endorse the Green Paper's complete ban on non-arm's-length transactions; however, some selective ban, as suggested in one form or another in the Senate, Dupré, and Blenkarn Reports, appears warranted. In particular,

14 We recommend that no financing be made available by any financial institution to any director or manager of the company. When the institution is closely held, no financing should be made available to any shareholder that owns more than 10 per cent of outstanding voting shares. We further recommend that any financing made available to any company with which directors, shareholders, or managers are associated be reviewed by a special committee of the board of directors.

Some legislation already contains provisions of this sort. The *Bank Act* generally prohibits loans to employees and directors unless they are secured by a mortgage or, if unsecured, have a term of less than a year or are below a specified amount. The federal *Trust and Loan Companies Acts*, the *Canadian and British Insurance Companies Act*, and the *Investment Companies Act* contain an outright ban. The *Foreign Insurance Companies Act* contains no prohibition. As for the caisses populaires legislation in Quebec, loans to officers and employees must not be made at preferential rates. In the credit unions legislation of Ontario, Saskatchewan, Alberta, and British Columbia, special approval from the institution's board of directors is usually required. Under the *Ontario Trust and Loan Act* revisions, loans to officers and directors are permitted, provided that they receive prior approval from the board of directors and that they are a normal part of business. Our recommendation would provide for uniformity across institutions. Institutions should ensure that the special committees of the board referred to in our recommendation are effective. More generally, their examination should extend to significant non-arm's-length transactions.

15 We recommend that each financial institution be required to establish a committee of the board of directors to examine non-arm's-length transactions.

The committee, composed of members, a majority of which, if not all, would be outsiders to the firm or the holding group – even when the institution or group is

closely held – should have the authority to prohibit a transaction, or to reverse one already made, if it deemed it not to be in the interests of minority shareholders, depositors, or other customers.

A control on certain transactions is not the only form of protection against abuses. The availability and dissemination of information is another form of protection.

16 We recommend that financial institutions disclose to their customers the major conflict-of-interest situations in which they find themselves and that the relevant supervisory authorities monitor such disclosure.

Any institution should be required to disclose its ownership links with other financial institutions. When an institution is associated with a securities dealer, it should be required to release the names of companies for which that dealer acts as an underwriter. It should also be required to release the names of mutual funds originating with associated companies. Ultimately, determination of the matters to be disclosed would rest with the relevant regulatory authority.

The Mixing of Financial and Non-Financial Activities

Financial and non-financial activities have been historically kept separate by regulation in order to avoid abuses with regard to conflict of interest and self-dealing. The mixing of financial and non-financial activities can lead to abuses and financial difficulties, particularly in the context of the existence of minority shareholders. Such a mixing can strain the liquidity back-up provided by financial institutions when an associated non-financial corporation faces difficulty. Furthermore, the mixing of financial and non-financial activities can lead to the misallocation of resources as a result of the favourable treatment afforded the non-financial companies. Consequently,

17 We recommend that a financial holding group not include a non-financial corporation among its subsidiaries, except for ancillary-support companies.

The rationale in the current legislation for permitting financial institutions to own some non-financial subsidiaries is that the latter either provide services to the institutions themselves (e.g., computer services) or are closely related to the activities of the financial institutions (e.g., real estate brokerage). Some definition of ancillary services is provided in the federal *Trust Companies Act* (section 68.2) and *Loan Companies Act* (section 60.2), and in the *Canadian and British Insurance Companies Act* (section 65.1). It should be ultimately left to the regulator to decide which ancillary activity is appropriate and which is not.

Recommendations 14 to 17 would reduce instances of conflict-of-interest abuses and self-dealing without restricting in any way the flow of information between various financial institutions and without placing undue constraint on the allocation of financial resources among affiliated companies. In particular, the one-institution/one-function structure would substitute for "Chinese Walls" in the separation of functions between which conflicts of interest might arise. Of course, neither would preclude the flow of information at the executive level. Trustees would have to disclose to their clients any ownership links with other institutions that could place them in a situation of conflict of interest. Furthermore, the duties of a trustee, as defined in trustee legislation, provide guidelines to resolve many conflicts.

Abuses of conflict-of-interest situations, self-deals, and fraud may affect minority shareholders, depositors, and other customers of financial institutions. Borrowers are affected when the management of an institution does not sufficiently uphold their interest. Recommendations 16 and 17 should deal with such instances. With respect to minority shareholders and to depositors, it is the former that bear the initial impact of a self-deal, through lower profitability and a decline in the value of the shares of the firm. Depositors basically remain unaffected until the firm fails. Recommendations 14, 15, 17, and 19 are aimed at protecting the minority shareholders; Recommendations 5, 14, 15, and 17 are directed also at the protection of depositors.

Ownership restrictions limiting the stake of individuals and companies in a financial institution are often viewed as a further, and sometimes better, safeguard against abuses, particularly when depositors are involved.

Domestic Ownership

But our analysis has shown that concentration of ownership has increased as a result of the growth of holding groups and a number of mergers and acquisitions. In fact, today there are three different models of ownership. Schedule A chartered banks are widely held, with no individual shareholder owning more than 10 per cent of outstanding shares. Credit unions and mutual insurance companies are also widely held institutions. On the other hand, several trust and loan companies are closely held by individuals or firms. Finally, several trust companies and insurance companies have majority shareholders, with large portions of their shares held by the public at large.

As discussed in the Blenkarn Report, closely held ownership improves the performance of financial institutions, particularly smaller ones, through a hands-on management approach; but it also facilitates self-dealing. In our research we have found, however, that the incentive to self-deal in a closely held institution depends on whether the owner is an individual or a firm and on the level of control over the institution. An individual owner may find it easier to abuse the trust of depositors if he does not share ownership with minority shareholders. On the other hand, incentives to abuse conflict-of-interest situations and to self-deal are somewhat less when one company owns 100 per cent of another. In this case, the benefit to the parent company from self-dealing with its subsidiary may be erased by the resulting decline in the profitability of that subsidiary. In the presence of minority shareholders in the subsidiary, the parent will reap the benefits of the transaction, whereas the decline in the subsidiary's profitability is shared by all shareholders – hence the need for the latter to control a sufficiently large proportion of shares to protect their interests.

Closely held ownership by a large company facilitates the raising of funds, particularly new equity. Closely held ownership by an individual may limit the financial resources available for growth. Some argue that a system with a majority shareholder and a large float of shares in the hands of the public would provide for closer involvement of the owners in the management of the firm but would also provide access to a larger pool of financial resources.

The various reports have taken different positions on the ownership issue. The Green Paper would allow institutions, independently of their size, to be closely held – with the exception of Schedule A banks. While favouring widespread ownership, the Blenkarn Report opts for a sliding scale based on asset size, in recognition of the benefits of a major shareholder for smaller institutions. Furthermore, non-financial institutions would be prohibited from owning more than 30 per cent of the voting stock of a financial company. The Dupré Task Force supports widespread ownership; and the Senate Committee, while not imposing direct domestic-ownership restrictions, recommends that where a financial institution has a controlling interest in another firm operating in a different pillar, either the parent company or its affiliate must have 35 per cent of their shares traded publicly.

While widespread ownership is the best insurance against abuses, the reorganization of the financial system implied by our previous recommendations would result in a number of institutions being closely held within a holding group. The next two recommendations are aimed at reconciling the concept of widespread ownership with the holding-group structure.

18 We recommend that no single individual or company, whether Canadian or foreign, own more than 10 per cent of the capital of an independent financial institution or holding group with over $10 billion in domestic assets. Closely held institutions or holding groups with over $10 billion in domestic assets as of 1 January 1987 would not have to undergo any change in ownership, but any subsequent increase in equity should be widely distributed, and the financing of future growth in assets should be subject to specific guidelines as to the mix between debt and equity.

The criterion that no shareholder should have an interest greater than 10 per cent is a well-accepted measure of widespread ownership and the one retained in the *Bank Act*. The proposal of a sliding scale relating the ownership structure to the size of the institution implies that abuses are related to size; they are not, in fact, although their impact might be.

The ownership test should be applied at the highest level. Banks, investment dealers, insurance and trust companies, and others could be closely held by a holding company, as long as the holding company meets the ownership criteria. The test should also apply to domestic assets only, provided that liabilities booked in Canada are not used to support foreign assets and that foreign operations do not endanger the solvency of the institution.

The $10-billion cutoff for closely held ownership of holding groups and independent financial institutions is aimed at recognizing that many firms are currently closely held and that there are advantages in such an ownership structure for smaller institutions, particularly those in their early stage of growth and development. Other institutions have a major shareholder, and some consider it a worthwhile model of ownership structure. Because closely held institutions with assets of more than $10 billion as of 1 January 1987 would have their ownership structure grandfathered, they would not be required to engage in a divestiture process that could be complicated and disruptive to financial markets, at least in the short run. Constraints on the funding of the expansion of the capital base have been imposed on grandfathered institutions so that future growth will be accompanied by a dispersion of ownership. (Leverage would be controlled by the relevant regulatory authorities.)

On the basis of 1985 data, the grandfather clause would apply to the following companies: in the trust industry, Canada Trust (Royal Trust is already a member of a holding group); among holding groups: Trilon, and possibly Power Financial. The other institutions with assets of more than $10 billion are already widely held. This is true of all chartered banks and of the Desjardins Group. Lowering the cutoff

point to $5 billion would have required a much higher number of exceptions.

On the other hand, several institutions that currently fall under a widespread-ownership rule have assets below the $10-billion mark. These are the Bank of Alberta, the Western and Pacific Bank, the Bank of British Columbia. These banks would not have to meet the 10 per cent rule under our proposal; nor would banks that are members of a holding group. The ownership requirements of the *Bank Act* should be amended accordingly. (The Continental Bank is in the process of merging with a Schedule B bank and thus would no longer need to meet ownership requirements.)

What should be done when a holding group or an independent institution reaches the $10-billion limit? One approach would require that any further expansion in capital be effected through widely distributed new equity issues; another would be to oblige the institution to become widely held. This could be done gradually, so that widespread ownership would be achieved by the time the assets reached a specified level – say, the $15- or $20-billion mark. The latter solution appears to be preferable if the objective of a widespread-ownership structure for the Canadian financial system is to be achieved.

19 We recommend that financial institutions linked together within a holding group be wholly owned by the holding company, unless at least 35 per cent of their voting shares are widely held by other investors.

As we have shown, 100 per cent ownership of one firm by another reduces the benefits of various abuses and of self-dealing for the parent company. On the other hand, a sufficiently large number of shares in the hands of minority shareholders might provide a useful set of checks on the majority shareholder, particularly when mismanagement or abuses of various sorts could affect depositors who have entrusted their money to the financial institution. The 35 per cent figure in Recommendation 19 provides a protection for minority shareholders, similar to that offered by the *Canadian Business Companies Act* through the "special resolution" clause requiring a majority of not less than two-thirds of shareholders to implement certain modifications to the corporation's operations. It might also be advisable to guarantee to minority shareholders a representation on the board of directors. The alternative, in the absence of a publicly held float of 35 per cent of the voting shares, is for the institution to be wholly owned by the holding company.

This recommendation will require some changes in the internal organization of existing holding groups. For instance, Crown Financial Group owns 92 per cent of Crown Life and 75 per cent of Coronet Trust; Power Financial owns 98 per cent of the Investors Group and 85 per cent of Great West Life Corporation. Two avenues are open for members of a financial holding group that would not meet the criteria outlined in Recommendation 19. Additional issues of shares could bring the level of minority participation to 35 per cent, or an exchange of shares of the holding company for shares of the member in question could bring to 100 per cent the stake of the holding company. Swaps of shares do take place on the Canadian financial market, the latest involving Great West Life and Great Westco.

The possibility of bypassing the ownership restrictions would still remain. Therefore,

20 We recommend that when an individual or a non-financial corporation has interests in more than one financial institution or financial holding group operating in Canada, with combined unconsolidated domestic assets of more than $10 billion, such interests in each shall not exceed 10 per cent.

This would prevent an excessive concentration of power in the financial sector. Particularly, an individual or company could not wholly own a number of institutions whose assets were less than $10 billion individually but well beyond that figure when combined. Furthermore,

21 We recommend that any purchase of more than 10 per cent of the capital stock of a financial institution be subject to prior approval from the relevant regulatory authority.

This recommendation reinforces the ownership restrictions and is aimed at preventing purchases or takeovers that would have an adverse effect on competition in the financial industry. Bill C-103, recently introduced in the wake of the takeover of Canada Trust by Genstar and of Genstar by Imasco, already contains such a clause. Our recommendation would extend the requirement of prior approval to all categories of institutions. An alternative would be the full disclosure of the names of all purchasers, with the relevant regulators being granted the power to reverse such transactions.

Foreign Ownership

The ownership rules recommended above should apply to both Canadian and foreign institutions. Given the openness of the Canadian economy and the growing internationalization of financial markets, we have to give further consideration to the role to be played by foreign institutions within our proposed new configuration.

The other reports have diverging views on the treatment of foreign institutions. The Green Paper

would maintain the existing limits on foreign ownership. Currently, few constraints exist in the life insurance industry; foreign banks have to establish subsidiaries to be registered under Schedule B of the *Bank Act*, and limits on the growth of the assets of these subsidiaries are imposed; foreigners are restricted in their ownership of registered securities firms in Ontario, although they can operate freely in the so-called "exempt market"; few restrictions exist for securities firms operating in Quebec. The Blenkarn Committee recommended that foreign interests be treated in the same fashion as Canadian firms. The Senate Committee Report, while allowing free entry by foreigners, would establish control over the transfer of ownership to foreign interests.

For our part, we believe that competition on domestic markets is enhanced by the entry of foreign financial institutions. Allowing foreign institutions to be active in Canadian financial markets also furthers the cause of our own institutions in countries that require reciprocity.

22 We recommend that foreign institutions be allowed to enter gradually all financial areas and that such entry be based on reciprocity by the country of origin.

This would enhance competition on domestic financial markets and the deployment of Canadian financial institutions around the world. Free entry – an important contributor to increased competition and accessibility of financial products – should, however, be associated with reciprocity conditions that allow for the development of Canadian institutions abroad. We recognize that this could involve a lengthy negotiation process, but the basis for reciprocity has to be well defined. For instance, because of different jurisdictional structures between Canada and the United States, U.S. banks, by incorporating a subsidiary under the *Bank Act*, would gain access to Canada from coast to coast, while Canadian banks wishing to operate south of the border would have to abide by regulations that limit interstate branching and operations. For Canada, being restricted to New York State would indeed be a limited interpretation of reciprocity.

Institutional Practices and Management

Beyond the issues of ownership and abuses, our investigation has pointed to the existence of other areas of concern. For instance, auditors are a key group of officials who have drawn criticism from some reports because of the ambiguity of their accountability and of a perception that they have failed to react adequately to situations of abuse or financial difficulty. We agree with many of the measures proposed in the reports of the Senate Committee, the Dupré Task Force, and the Blenkarn Committee. Without dwelling on details,

23 We recommend that the reporting accountability of the auditors – and actuaries, where applicable – of financial institutions be clarified so that they will be required to report to the relevant supervisory authorities any material wrongdoing they have uncovered or serious concerns they may have about the financial health of the institutions.

Auditors are required to report situations that would make a material difference to financial statements, as prepared and presented by management to shareholders. While it is an accounting concept, "materiality" is not well defined. Generally, the auditors' report indicates whether the institution's financial statement presents fairly its financial position and the results of its operations for the year, in accordance with prescribed accounting principles. According to the Canadian Institute of Chartered Accountants (CICA) Handbook, shareholders can sue the auditors if, in their opinion, the latter have failed to report any fraud or error they have found in their own investigation, or if they do not indicate the nature of the problems they have detected during their audit when management has refused to change financial statements. But facts of importance go beyond financial statements and clear instances of fraud. They may involve conflict-of-interest abuses, inappropriate transactions, or transactions that could endanger the future solvency of the institution. While some of these reporting requirements are set out, to varying degrees, in several Acts, the auditors' obligations remain vague and incomplete (see Chapter 4 of *A Framework for Financial Regulation*).

The Senate Committee Report recommends that the audit committee of the institution establish guidelines for the auditors, subject to regulatory approval, as to what is or is not "material." Given that conditions on financial markets are in a constant state of flux and given the usually rapid development of new instruments and practices, it should be the regulator's responsibility to review, on a continuing basis, what is to be considered material. It remains the auditor's responsibility, as the first person in the field, to make his own judgment as to the materiality of the information – a judgment for which he will be accountable to the relevant regulator. In particular, auditors should look into the risks undertaken by the audited institution, as these may endanger its future financial health. They should also look at the level of provisions for losses. Our recommendation calls for a clarification of the auditors' reporting responsibilities. In a report on the operations of the Office of the Inspector General of Banks, submitted in April 1986 to the Minister of State for Finance, the consulting firm, Coopers and Lybrand, calls for an extension of reporting to include the management of risks by banks.

In certain groups of institutions, especially life insurance and property and casualty insurance compa-

nies, the actuary plays an important role in establishing the ability of a company to meet its future commitments. Thus their inclusion in our recommendation aimed at strengthening the reporting accountability of professionals involved in the assessment of the soundness of financial institutions.

Auditors should be supported by a strengthened internal audit committee. Such committees do currently exist in many institutions but with rather limited powers. While the establishment of an audit committee of the board is mandatory under the *Bank Act*, the role and procedures of such committees vary between banks. In general, their role is to ensure the production of accurate and reliable data. In many cases, audit committees do not review provisions for losses, although in some banks they may play a wider role in assessing outstanding credit. It is important that such committees take a more active role in assessing credit risks and provisions for losses.

It should, however, be noted that external auditors and the internal audit committee cannot perform their tasks without the full cooperation of the institution's management. Indeed, the monitoring of the performance of a financial institution depends on information flowing through a number of individuals whose closeness to the firm's management increases as one moves along the chain of responsibility. For example, the Inspector General of Banks depends on the external auditors, who depend on the banks' internal auditors, who in turn depend on management. Thus,

24 We recommend that the management of financial institutions be liable for the quality of the information provided auditors.

While management is already liable for keeping proper records and providing information to the auditors, our recommendation would go further, imposing a liability on management with respect to the quality and completeness of the information provided.

Two additional issues with respect to internal practices must retain our attention – namely, investment strategies and leverage.

Investment strategies for many groups of institutions, particularly trust and life insurance companies, and for pension funds have been governed to date by qualitative rules. These were aimed at increasing solvency. But they restrict the investment choices of institutions, and they reduce competition and the availability of financial products to all Canadians. Most of the other reports have recommended their replacement by quantitative rules. On the other hand, while quantitative rules force portfolio diversification, they do not guarantee the soundness of individual investments. Prudent investment may call for some blend of the two approaches. Investment rules should be the outcome of a process of consultation and cooperation between the relevant regulatory authorities and the management of institutions.

Concern with solvency and confidence calls for an adequate capital base. It would, however, be inappropriate to go beyond such a statement, as the minimum capital base needed to operate a financial institution safely varies among lines of business and over time, particularly as a result of financial innovation. The pyramiding of capital among institutions, however, should definitely be prevented.

25 We recommend that when more than 10 per cent of the common stock or subordinated debt eligible to be counted as part of the capital base of a financial institution is owned by another financial institution, that portion of the capital be deducted from the capital base of the owning institution.

Double-counting of capital would be prohibited under the strategy presented by most, if not all, other reports. The pyramiding of capital cannot take place within a holding group, as our proposed framework would prevent subsidiaries of a holding company from investing in the equity of associated institutions. With respect to other institutions, care should be taken to ensure that measures designed to prevent pyramiding of the capital base do not, at the same time, prevent the normal investment of funds in good-quality equity capital – hence the 10 per cent cutoff point.

The Canada Deposit Insurance Corporation

The reform of deposit insurance is also a much-needed part of modernizing the existing regulatory structure. The one-function/one-institution approach, accompanied by more-efficient supervision, enhances the solvency of the financial system. Nevertheless, deposit insurance and compensation funds continue to play an important role in enhancing confidence and access. But care should be taken to ensure that they do not reduce competition and market discipline. In fact, many issues that have been the subject of much debate in relation to deposit insurance – such as the amount to be covered by insurance or the introduction of risk-related premiums and of co-insurance – take on a different significance, depending on whether they are looked at from a market-discipline, a confidence, or a consumer-protection point of view.

From the point of view of competition and market discipline, risk-related premiums are called for to reduce the negative impact of deposit insurance on excessive risk-taking. From a confidence point of view, risk-related premiums should be rejected, as they may negatively influence public confidence when they single out higher-risk institutions. Furthermore, in order to increase the stability of deposits, there should be no limit on deposit insurance coverage. From a consumer-

protection point of view, co-insurance from the first dollar, when it becomes effective in achieving market discipline, negates the very *raison d'être* of deposit insurance. Indeed, with co-insurance, the consumer who erred in leaving funds on deposit with a higher-risk institution may have to face some capital loss in case of failure. The original objective of deposit insurance – the protection of less-sophisticated depositors – is being lost. A system of co-insurance starting beyond a minimum level of deposit (say, $20,000) would afford some protection to the consumer. Furthermore, co-insurance by itself cannot increase market discipline unless it is accompanied by information that would enable a depositor to assess accurately the financial health of the deposit-taking institution. On the other hand, some limits on the dollar amount of deposits covered by insurance might be imposed, since the objective is to protect only the unsophisticated depositor and thereby provide access for all Canadians to the services offered by deposit-taking institutions, regardless of their income or degree of sophistication.

There is disagreement between the various reports on the level and form of deposit insurance – disagreement originating with the specific focus of each report, ranging from the importance of imposing market discipline to the importance of protecting the consumer. The Wyman Report came out in favour of co-insurance from the first dollar; the Dupré Report opted for a sliding scale of coverage, with deposits under $20,000 being fully insured and those over $80,000 having no coverage. The Blenkarn Committee recommended that the present coverage be retained, while the Senate Committee Report favoured a system close to that put forward in the Dupré Report, except that the actual numbers were somewhat different.

In the context of a fast-changing financial world, the maintenance of confidence and of consumer protection is of paramount importance. Consumer protection takes on special importance in a framework where the restrictions on the distribution of financial services are removed. In such an environment, deposit insurance should not be weakened. Consequently,

26 We recommend that all deposits, up to a maximum of $60,000, be fully insured by the Canada Deposit Insurance Corporation. We further recommend that a more generous limit be applied to deposits that form part of an RRSP.

Because they would operate under the *Bank Act*, deposit-taking institutions would qualify for CDIC insurance. The present arrangements with the Régie d'assurance-dépôts du Québec (RADQ – the provincial deposit-insurance board) could be continued as part of a delegation of powers. Currently all deposits in the Quebec branches of provincially incorporated financial institutions are covered by the RADQ, while deposits in the out-of-province branches of Quebec-incorporated institutions are covered by the CDIC. Mechanisms are in place to avoid an overlap in the supervision of institutions covered by the CDIC and the RADQ. Finally, the RADQ has a liquidity back-up agreement with the CDIC. Furthermore, should the means of payment become an instrument other than deposits, it should be protected by a form of insurance that would be developed at the appropriate time.

To avoid any unnecessary disruption to the existing financial environment, we have opted for the current $60,000 limit on coverage. Lowering that limit could reduce confidence in the financial system, and there is no compelling reason to raise it. Those reports which proposed that the maximum be raised to $100,000 did so in the context of the introduction of co-insurance. A more generous limit should apply to deposits that form part of an RRSP in order to protect the retirement income of older Canadians, particularly since it is likely to be the financially less-sophisticated individuals that would keep their funds in deposits, as distinct from a more diversified portfolio. Other measures, particularly closer supervision, would deal – albeit in imperfect fashion – with the excessive risk-taking induced by the existence of deposit insurance.

As a general rule, government should not provide a guarantee to uninsured depositors. When a major disaster looms on the horizon, however, government might consider taking over financial institutions that face serious difficulties or facilitating mergers with financially viable institutions. In such cases, measures should be considered to ensure that the shareholders bear at least some of the costs of the mismanagement of the institution.

27 We recommend that the Canada Deposit Insurance Corporation be granted the power to set premium rates.

The premium rates should be set by the CDIC's board of directors, which should include industry representatives. Because of the many technical problems with their implementation – referred to in Chapter 4 of *A Framework for Financial Regulation* – risk-related premiums cannot be introduced in the near future, although they are undoubtedly the best way to enhance market discipline in the context of the existence of deposit insurance. Furthermore, in envisaging the introduction of risk-related premiums, their possible negative impact on confidence should be fully considered.

28 We recommend that the Canada Deposit Insurance Corporation share supervisory powers with the federal regulator of banks.

The CDIC should be involved in the supervision of banks, on the premise that he who ultimately pays the bill must be satisfied with the performance of those who may cause him to engage in expenditures. The

object of this recommendation is to provide the insurer with the ability to require changes in institutional behaviour in order to protect its contingent liability. We recognize that CDIC participation in the supervision of banks would require cooperation with the other relevant regulatory authorities.

Consumer Protection

Consumer protection should not be limited to deposits in financial institutions but should also extend to other financial transactions.

29 We recommend that life and general insurance companies, and investment dealers, be required to develop their own customer protection plans.

Such plans, some of which are already in place or in the development stage, should be strengthened and well publicized to enhance consumer confidence.

The opening of retail outlets for the delivery of a large number of services produced by distinct financial institutions raises important issues with respect to consumer protection. Although tied-selling would be prohibited (see Recommendation 7), there is a need to reinforce consumers' awareness of their sovereignty in the choice of the originator of the financial products they purchase.

30 We recommend that any institution delivering, in a single transaction, two products originating in separate institutions be obliged to inform customers of their option to buy the second product from other distributors.

The responsibility is placed on the delivering institution to inform the customer in the manner deemed most appropriate.

There is also a need to protect consumers with respect to the quality of the advice they receive. Currently, lawyers, financial planners, and investment counsellors have escaped regulation in some of their activities.

31 We recommend that financial planners and investment counsellors, together with lawyers managing estate and trust accounts on behalf of customers, meet minimum standards of behaviour, to be recognized through a special licence.

Financial planners have already been the object of attention by regulators. Securities commissions in Quebec, Ontario, and Alberta called upon the Canadian Association of Financial Planners to propose a plan for self-regulation by 15 August 1986. The Province of Quebec is particularly concerned with the qualification of planners who provide advice. It would like financial planners to show that they have received relevant training. The Commission des valeurs mobilières du Québec has put forth some concrete proposals to that effect. While self-regulation is appropriate in many cases, the protection of the consumer, which is at stake here, calls for more. Particularly, the licensing of financial planners would oblige them to establish separate trust accounts on behalf of the clients and force them to be covered by liability insurance. This would afford greater protection to the users of the services of financial planners. For planners, as well as investment counsellors and lawyers, licensing should also relate to advice and management activities. In the longer run, financial planners, investment counsellors, and lawyers should be required to adopt a "prudent-man rule" type of management for the funds that have been entrusted to them.

Concluding Remarks

A sound and efficient functioning of the financial system is of vital importance to the Canadian economy. Indeed, the financial system is the mechanism for making the payments associated with almost all transactions in the economy. It provides intermediation so that savings can be transferred to investors. In this way, risks are pooled and redistributed according to the preferences of savers and investors. The financial system also provides for the safekeeping of funds. By fulfilling these functions, the financial sector contributes to the accumulation of capital and facilitates trade among Canadians, and between Canadians and the rest of the world. It contributes to saving, investment, employment, economic growth, and social progress.

What is clear is that in matters of trade, investment, lending, and borrowing, decisions are being made on the basis of worldwide opportunities. Canadian financial institutions have shown extraordinary adaptability in fashioning services to meet this global challenge. It is important that the domestic regulatory structures governing financial institutions also adjust, at both the federal and provincial levels.

The Council is convinced that it is essential to foster competition if financial markets are to perform their vital role efficiently. We also recognize that financial markets will continue to face waves of change from new technologies and from the cycles of expansion and contraction of international financial flows. The existing regulatory framework has not been able to keep pace with changes in the marketplace. We believe that Canada must therefore adopt a new framework for financial regulation that will give full play to competition and at the same time buttress the solvency of institutions.

The new framework outlined in this statement imposes change on the institutions themselves, on

regulators, and on governments. The framework requires governments and regulators to introduce some new definitions of the basic functions of financial institutions. It forces these institutions to create a separate corporate entity for each function and then uses the mechanism of cross-ownership to give the institutions the scope to compete in all service areas.

The framework relies on a combination of ownership limits, corporate governance, and regulatory inspection to ensure that cross-ownership does not lead to harmful transactions that endanger the solvency of institutions or the fair treatment of consumers. We believe that managers, directors, auditors, and regulators have a shared responsibility for the health of the system. But we recommend strengthening the power of the regulator to act if the others fail to meet their obligations.

The framework also requires federal and provincial governments to work out ways to harmonize financial regulation. We do not believe it is necessary to centralize all financial regulation, but it is certainly essential to harmonize the rules of the game. Inconsistencies among jurisdictions create invitations to bypass the tightest regulations and thus weaken the whole system.

The changes being proposed require significant internal adaptation, but they are not radical. They do not involve changes in the relationship between the institutions and their customers. We believe the proposed adjustments are worthwhile when they are placed in the context of a system that would be better able to finance Canada's economic growth, to build world-class financial institutions that can compete on international markets, and to safeguard the soundness and solvency of the institutions upon which Canadians rely.

Appendix

Reports on the Canadian Financial System

	Green Paper and Wyman Report	Senate Committee Reports	Report of the Dupré Task Force	Blenkarn Report	Economic Council of Canada Report
Stated objectives of the reports	To develop a regulatory approach to financial institutions in order to better serve the public interest. To study and make recommendations on reforms to, and on the object, funding, organization, and public relations of, the Canada Deposit Insurance Corporation and on the supervision of member institutions.	To study the Green Paper and the Wyman Report.	To examine the organization and operation of financial institutions in Ontario and determine what pressures on the financial system may require attention from government.	To study the Green Paper, the technical supplement, and the Wyman Report, and to develop a regulatory approach.	To improve the private and public efficiency of the financial system by finding the best balance between the forces at play.
Role assigned to financial sector	To allocate credit, ensure the safekeeping of funds, and provide means of payment.	To transfer funds efficiently from lender to borrower.	To facilitate the flow of funds from savers to users of savings, and to allocate those funds efficiently without compromising the solvency of financial institutions.	(Not explicitly stated.)	To ensure the intermediation of funds and risks, the supply of information, the safekeeping of funds, and the maintenance of a payments system.
Institutional and related issues	To improve consumer protection. To promote competition, innovation, and efficiency (undefined). To enhance the convenience and options available to consumers in the market place. To promote international competitiveness and domestic economic growth. To control self-dealing and conflicts of interest. To broaden sources of credit.	To improve market discipline in the financial sector, regulatory discipline, and consumer protection.	To maintain solvency as a means of ensuring consumer protection and maintaining efficiency (undefined). To enhance market efficiency. To define ownership of financial institutions. To control conflicts of interest and self-dealing.	To protect the consumer. To improve competition and efficiency (undefined). To maintain the stability and soundness of the financial system. To control conflicts of interest and self-dealing. To improve corporate governance. To define ownership of financial institutions.	To examine diversification, conglomeration, ownership, conflicts of interest, self-dealing, solvency, and market discipline, as they affect the conditions of efficiency – namely, competition, confidence, and access.

	To ensure soundness of financial institutions and the stability of the system. To promote harmonization of federal and provincial regulatory policies. To improve market discipline in the financial sector.				
General approach to regulation	Regulation by institution. Diversification to take place through a holding company. Mutual companies to be permitted to raise funds for the expansion of downstream affiliates through the issue of subordinated debentures. Establish Schedule C banks to be given the same powers and to be subject to the same reserve requirements as current Schedule A and Schedule B banks, but they would be closely held institutions.	Regulation by institution. Financial institutions to be allowed to diversify their operations through four general avenues: - within-institution expansion of powers; - subsidiaries; - upstream and downstream holding companies; and - networking.	Regulation by institution. Ownership links between financial institutions to be permitted only through a financial-holding-company device.	Regulation by institution. Financial institutions to be allowed to diversify their operations through four general avenues: - within-institution expansion of powers; - subsidiaries; - upstream and downstream holding companies; and - networking.	Government to adopt regulation by function. Each institution to be limited to the performance of a single major function, falling under single regulatory authority. Any institution providing a means of payment to be considered a bank, operating under the *Bank Act*. Process of reorganization to be gradual, with target dates to be established. All levels of government to undertake to amend all legislation as expeditiously as possible to accommodate the new framework. All Acts and legislation governing financial institutions to have sunset clauses and to be reviewed at the same time.
Financial holding companies	Requirement to form a holding company for all investors who hold more than 10 per cent of two or more regulated financial institutions, one of which is federally incorporated. Avoid double-counting of capital.	Double-counting of capital not to be permitted. Securities firms to be treated like any other financial institution, in terms of being able to be part of an upstream or downstream holding company or to be subsidiaries of a financial institution	This device to be made available to domestically owned banks, as well as to other types of financial institutions. Means must be found to ensure that mutual companies will not be disadvantaged vis-à-vis stock companies in their capac-	Rejects the compulsory aspect of financial holding companies. Double-counting of capital in downstream holding companies and subsidiaries (except real estate subsidiaries) not to be allowed, and such investments not to be limited to a specified	Diversification into any function to be allowed only through a financial holding group. Members of group can sell assets and lend funds to one another, within pre-set limits, except when one member is facing serious financial difficulty.

	Green Paper and Wyman Report	Senate Committee Reports	Report of the Dupré Task Force	Blenkarn Report	Economic Council of Canada Report
Financial holding companies	Cooperative credit associations registered under the federal *Co-operative Credit Associations Act* to be allowed to create downstream financial groups similar to FHCs. Mutual companies to be allowed to create downstream affiliates.	operating under another segment. Securities firms to be given powers similar to those of other financial institutions, in terms of being able to acquire subsidiaries and to form downstream holding companies. Schedule B banks could be part of a holding company.	ity to affiliate with other institutions, whether by way of holding companies or subsidiaries.	percentage of assets or capital of the parent institution. The Canadian Co-operative Credit Society to be given the same powers of diversification as those contemplated for non-bank financial institutions. Ways and means must be developed to enable CCCS to establish a bank, should the provincial central so desire.	Financial holding groups to supply financial statements for the group as a whole and to be monitored for solvency. Financial holding groups not to include non-financial corporations, except for ancillary services. Federal and provincial governments to monitor holding groups for solvency. Avoid pyramiding of capital.
Commercial lending	Non-bank financial institutions can only engage in commercial lending through an affiliated Schedule C bank.	An all-inclusive maximum of 20 per cent of assets to be established for trust companies, insurance companies, and credit unions.	For trust and loan corporations: - approval of the Superintendent of Deposit Institutions; - restrictions to 10 per cent or less of total assets; and - minimum capital of $15 million.	Investments for which no specific aggregate limits exist are to be considered as basket-clause investments. Basket-clause investments for all non-bank financial institutions to be established at 15 per cent of assets.	To be dealt with prudently as any other investment power.
Networking	Removal of restrictions that inhibit networking between institutions. Prohibition of tied-selling in all networking arrangements.	To be allowed, but tied-selling prohibited.	To be allowed, but regulatory approval to be required. Institutions to be required to disclose to their customers the existence of networking arrangements and the availability of alternative sources for similar services.	Networking to be permitted for trust and loan companies, insurance companies, cooperatives, and banks after the 1990 *Bank Act* revision. Tied-selling to be prohibited. Institutions not to be allowed to share confidential information without the written consent of the client.	All types of networking, cross-selling, and cross-referral to be allowed. Tied-selling to be prohibited. Institutions selling two products originating with different institutions to advise customer of option to buy the second from another distributor.

Investment powers	Quantitative rules to replace present quality tests.	Quantitative or prudent-portfolio approach to investment to be monitored by the investment committee of the board of directors.	Specific asset mix proposed. Current rules to be replaced by a prudent-investment standard. Creation of investment committee of the board of directors to adopt policies designed to avoid undue concentration.	Specific asset mix proposed for selected financial institutions.	Investment powers to be determined by what is considered prudent for each function.
Conflict of interest and self-dealing	Complete ban on non-arm's-length transactions. Creation and maintenance of a "Chinese Wall" between fiduciary operations within a trust company and all other financial operations of the trust company and of its affiliated companies. Creation of a Financial Conflict-of-Interest Office to assist individuals who wish to make a claim for damages against financial institutions.	Implementation of a three-pronged procedure incorporating a system to review non-arm's-length transactions: - tier one: selective ban on self-dealing transactions; - tier two: creation of a Business Conduct Review Committee to review in advance all non-arm's-length transactions; - tier three: pre-clearance with the primary regulator for certain kinds of non-arm's-length transactions. Combination of enhanced disclosure, effective corporate governance, and the establishment and monitoring of "Chinese Walls" to control abuses in financial institutions. Financial holding companies to be prohibited from engaging in non-financial activities.	Activities with related parties to be prohibited, subject to limited exemptions (unless true market value can be objectively ascertained by independent means). Approval to be given by the Lieutenant-Governor in Council to otherwise prohibited transactions. Obligation for professionals to disclose any conflict-of-interest breach. All related party transactions to be disclosed in financial statements. A securities firm should be prohibited from underwriting any security of a non-industry investor or of a person or company related to that securities firm that holds more than 10 per cent participation. Directors representing the ownership interest of a financial intermediary in a securities firm to be required to be absent when any matter in which the intermediary that they represent has an interest, is being discussed or voted upon by directors.	Freedom to engage in non-arm's-length transactions, except those that are likely to have a significant impact on the institution's solvency. National Financial Administration Agency (NFAA) to monitor all non-arm's-length transactions. Creation and maintenance of a "Chinese Wall" to prevent the flow of information between certain departments within an institution. 30-day pre-notification to NFAA or the appropriate regulator for related-party transaction greater than $1 million.	Committee of board of directors to examine non-arm's-length transactions. No financing to be made available to any director or manager. When institution is closely held, no financing to be made available to any shareholder that owns more than 10 per cent of outstanding voting shares. Any financing made available to any company with which directors, shareholders, or managers are associated is to be reviewed by special committee of the board. Positions of conflicts of interest to be disclosed to customers.

	Green Paper and Wyman Report	Senate Committee Reports	Report of the Dupré Task Force	Blenkarn Report	Economic Council of Canada Report
Conflict of interest and self-dealing			New requirements for exempt market participants.		
Domestic ownership	No ownership restrictions.	Where a financial institution has a controlling interest in another financial institution operating in a different segment, either the institution itself or its affiliate must have 35 per cent of its shares traded publicly. Ownership restrictions imposed on Schedule A banks are to remain in place.	Approval of new entrants and of changes in ownership and control. In favour of widespread ownership. Non-industry investors to be permitted to own in the aggregate up to 49 per cent of voting rights in, and 49 per cent of the participating securities of, a securities firm registered in Ontario provided that no single non-industry investor owns more than 20 per cent of either the voting rights or participating securities.	Limits to be established on the basis of domestic-assets size. Non-financial institutions to be prohibited from owning more than 30 per cent of a financial affiliate. Ownership to be applied at the first level where there is a non-financial interest. Five years to meet these requirements.	Widespread ownership most desirable. Widespread ownership to be defined as no one owning more than 10 per cent of institution or holding company. Ownership to be widespread for all independent institutions or financial holding groups with domestic assets of over $10 billion. Existing closely held entities with over $10 billion in assets to be grandfathered, but increases in equity to be widespread. Financial institutions in holding group to be wholly owned by the holding company unless 35 per cent of their voting shares are widely held by other investors. Restrictions to be imposed on sizable ownership in more than one financial institution. Any purchase of more than 10 per cent of capital stock of a financial institution to receive prior approval.
Foreign ownership	Accepts existing foreign ownership restrictions.	Transfer of ownership or control of financial institution to foreigners restricted.		No special foreign ownership rules.	Foreign institutions to be allowed to enter gradually, on condition of reciprocity.

		No control of new entrants.		Distinction between Schedule A and Schedule B banks to be eliminated.	
Capital base	Initial capital requirements should be raised significantly; CDIC, in conjunction with the regulator, should formulate appropriate levels.	Higher initial capital requirements to be imposed.	Minimum capital of $15 million to be required for loan and trust corporations that want to enter commercial lending.	Minister of Finance to have discretionary power to review and revise minimum initial capitalization. Life and trust companies to be allowed a five-year transition period to comply with new capitalization requirements. Stock and mutual insurance companies to be allowed to issue preferred stocks and subordinated debentures.	Capital base to be what is considered prudent for function.
Leverage	New leverage rating system to be developed with the risk profile of assets being a key determinant.	CDIC to have the authority to alter leverage ratios of member institutions.	Increases in borrowing multiples in excess of 10 times for trust and loan corporations to be subject to prior approval. Information as to increases in the borrowing multiples to be deposited with a standing committee. Annual review and possible correction of the borrowing multiples for each trust and loan corporation by the Superintendent of Deposit Institutions.	Permissible leverage for all deposit-taking institutions to be reduced to between 10 and 20 times. Operation with a leverage above the limit to be allowed only when solvency and market conditions are deemed appropriate.	Leverage to be determined by regulators.
Reserve requirements	Removal of requirements on bank term deposits with a term to maturity of at least a year and not encashable for at least a year from their date of issue.	Bank of Canada to pay interest on bank cash reserves. Interest not to be paid on bank excess reserves.		Elimination of the requirement for banks to maintain non-interest-bearing cash reserves.	Reserve requirements to be the same for all institutions performing a banking function.
Deposit insurance	Co-insurance system covering 90 per cent of individual deposits	Full insurance for the first $25,000 and 80 per cent for the next $50,000, with	Under $20,000: fully insured.	Present coverage of up to $60,000, applying to all deposits irrespective of	Present coverage of up to $60,000, applying to all deposits, to be retained.

	Green Paper and Wyman Report	Senate Committee Reports	Report of the Dupré Task Force	Blenkarn Report	Economic Council of Canada Report
Deposit insurance	between $0 and $100,000 to be phased in over a reasonable period - three years, for example.	amounts adjusted for inflation.	$20,000 to $60,000: 75 per cent insured. $60,000 to $80,000: 50 per cent insured. Over $80,000: not insured. Deposits in RRSPs to be included.	their term to maturity, to be retained.	More generous limit on coverage of deposits in RRSPs.
Uninsured deposits				Government not to bail out uninsured depositors. Regulatory agency to develop and implement an uninsured-depositor cash-advance program.	
Compensation funds	Compensation funds for insurance companies to be based on same principles and structure as deposit insurance.	Securities industry and life insurance industry encouraged to develop contingency funds and welcome to join the CDIC.	Accelerate the development and implementation of industry compensation funds with a co-insurance element.	Two separate mandatory tax-free funds to be created for life and casualty, as well as property insurance companies. Funds to be self-supporting.	Insurance and securities industries to be required to develop consumer protection plans.
Brokered deposits	CDIC to have powers to: - impose freeze on brokered deposits; - put ceiling on the ratio of brokered to total deposits; and - impose a modest annual growth rate.	The extent of brokered deposits to be reported if in excess of a certain amount.	Disclosure conditions.	NFAA to develop procedure to monitor brokered deposits.	
CDIC	All deposit-taking institutions to be required to apply for insurance. Granting of insurance to be a matter of discretion for CDIC.	CDIC to have the power to specify minimum requirements where regulations and by-laws of members are not adequate. CDIC to have a range of powers to restore an insti-		CDIC is to become part of the National Financial Administration Agency (NFAA).	CDIC to share supervisory powers with bank regulators.

Approval for insurance to be a condition for granting a new charter.

CDIC to establish standards for insurance.

CDIC to have the power to vary and amend the contract of insurance appearing as a Schedule to its Act.

CDIC to have the power to set premiums.

CDIC to review the contracts of insurance annually.

CDIC to have the power to terminate a federally incorporated member's insurance for cause.

CDIC to have the authority to step in and take action if it becomes concerned that necessary action is not being taken by the responsible regulator.

CDIC should maintain its own complete and current data bank of information on insured institutions.

CDIC to develop performance-measurement standards as an early-warning system and a performance-rating system.

Member institutions required to furnish CDIC with the prescribed information it needs.

CDIC to engage a small core of highly competent professionals to monitor the performance, and to carry out inspections, of member institutions.

tution back to financial health.

The power to close down an institution must be a ministerial or judicial decision.

CDIC to undertake specific measures to limit its liabilities upon deciding that an institution is no longer viable.

CDIC to be granted a special status to make direct representation to the authority overseeing the liquidation process, but should not act as a liquidator.

CDIC to become involved in the supervision and regulation of institutions that fall below some minimum threshold level in terms of the early-warning system.

CDIC to be constituted as a separate institution with its own board of directors.

Membership in CDIC to be a privilege and subject to standards.

The powers associated with an insurer with respect to solvency to be delegated to, and exercised by, the primary regulators.

CDIC to report to the Minister of Finance, with the relationship modeled after that of the Bank of Canada.

In the normal course of events, CDIC to delegate its regulatory authority to the primary regulators.

	Green Paper and Wyman Report	Senate Committee Reports	Report of the Dupré Task Force	Blenkarn Report	Economic Council of Canada Report
CDIC	CDIC to be given the power to levy significant penalties to ensure compliance with its Act, regulations, and guidelines. CDIC to set and maintain proper financial standards and to have adequate capacity to supervise member institutions.				
CDIC funding	Premiums to be raised from 1/8th of 1 per cent to 1/16th of 1 per cent of insured deposits over the next two years with the target size of the fund to be fixed at 0.75 per cent of insured deposits. CDIC to issue $1 billion of floating-rate preferred shares.	Existing deficit to be financed by a series of surcharges over a 10-year period. CDIC to operate on the basis of a series of independent pools or segregated funds, with a target of 0.75 per cent of the insured deposits. CDIC to have the ability to borrow both from the fund and from the provincial equivalents, and to float guaranteed debt issues.		Premiums to be raised from 1/8th of 1 per cent to 1/16th of 1 per cent of insured deposits until the end of December 1986. Future premiums to include a surcharge retiring the current deficit in between 10 and 25 years.	Board of directors with industry representatives to set premium rates.
Supervisory structure and powers	Consolidation of the Office of the Inspector General of Banks and the Department of Insurance supervisory functions into a unique supervisory body. The proposed unique supervisory body would have the following powers: - to gain access to the records and accounts of an FHC and member firms; - to issue cease-and-desist orders; - to prohibit changes in the control of supervised institutions; - to appoint a curator;	Favours the present system, which aligns regulators and institutions according to the core function. Greater discipline with respect to all four regulatory components: - CDIC; - primary regulators; - auditors; - corporate governance. Cross-pillar activities to be monitored by one of the primary regulators. Increases in regulatory powers to be restricted to	Regulation, supervision, and policy direction of financial institutions (Ontario) to be transferred to an Office of Financial Institutions (OFI) of the Ministry of Treasury and Economics. Formation of a policy committee within this new Office to review and advise on all issues pertaining to the regulation, supervision, and policy direction of financial institutions. The OFI to develop a mechanism to recover	Creation of a National Financial Administration Agency (NFAA) to administer consumer protection plans and to act as the regulatory and supervisory agency for all federally, and where appropriate, provincially incorporated institutions. NFAA to establish conditions for membership with respect to protection plans and to act as a direct provider of deposit insurance, as administrator of insurance policy-holder compensation plans and as a lender of last resort to	Regulators to have increased powers. Regulators of a member of holding group in difficulty to inform regulators of other members of group. Early-warning systems to be developed for all institutions.

- increased powers to take control of assets of supervised institutions;
- to deem specific transactions not to be at arm's length;
- to force the divestiture of prohibited investments or loans;
- to obtain information on loans; and
- to obtain information on the ownership of an FHC and member firms.

areas where existing powers limit the ability to monitor the soundness and solvency of an institution or to restore problem institutions.

Primary regulators to be required to develop a computerized data base to serve as the building block for an early-warning system.

regulatory costs through direct levies on institutions.

Provincial and federal regulatory authorities to disclose and exchange information between themselves and with the CDIC, including information on risks being assumed by institutions.

Regulatory authorities to be given the power to investigate conflict-of-interest complaints raised by the public.

The Government of Ontario to direct relevant regulatory authorities to develop and implement an early-warning system.

Amendments to be made to the statutes governing Ontario financial institutions, to require them to assemble and transmit any required data to the relevant regulatory authority.

provincial cooperative stabilization funds.

NFAA to develop the necessary capability to perform on-site inspections of chartered banks.

One or two auditors of a bank to be appointed by, and report to, the NFAA in accordance with NFAA instructions.

NFAA to conduct annual (or as often as deemed necessary) meetings with the shareholders' auditors and the audit committee of a bank.

NFAA to develop the necessary procedure for institutions to report and disclose the fee income relating to restructured loans and amount of non-accrual loans and interest.

NFAA to have the power to appoint a curator, with grounds to take immediate control of troubled institutions and:
- to issue cease-and-desist orders;
- to suspend or remove directors and executive officers;
- to obtain information on the ownership of an FHC and member firms;
- to require declaration of interests of substantial shareholders;
- to force divestiture of prohibited investments or loans;
- to specify asset values;
- to deem specific transactions not to be at arm's length;
- to require restoration of assets illegally paid out.

	Green Paper and Wyman Report	Senate Committee Reports	Report of the Dupré Task Force	Blenkarn Report	Economic Council of Canada Report
Supervisory structure and powers				Statutes creating financial intermediaries to be amended to increase the penalties and the provisions making a matter illegal. Criminal Code to be amended to impose criminal penalties in the case of gross negligence.	
Federal-provincial harmonization	CDIC to expand its public-relations role with member institutions, depositors, and governments.	Federal government to take the initiative to establish, with provincial governments, a Permanent Committee of Ministers Responsible for Financial Institutions and responsible for achieving policy harmonization.	Governments of Canada, the provinces and the territories should initiate discussions to establish a Council of Ministers Responsible for Financial Institutions, to review and consult on matters pertaining to the policies and regulatory practices governing financial institutions. Council to be staffed by a permanent secretariat.	Federal and provincial governments to pursue discussions to harmonize legislation, regulation, supervision, and enforcement of the Canadian financial system within the framework of NFAA. All federal legislation to be reviewed and revised on a decennial basis.	Provincial governments to put in place mechanisms to ensure interprovincial uniformity of regulation and to act as spokesman.
Corporate governance	Directors of an FHC and affiliated institutions should exercise a higher standard of performance and attention than currently required under the *Canada Business Corporations Act*.	Directors to exhibit a degree of skill that may reasonably be expected from persons of their knowledge and experience. Comprehensive indemnification provisions for a director against costs and expenses incurred in respect of a civil, criminal, or administrative action to which he is a party.	Each corporation should have a continuing statutory responsibility to satisfy the regulatory authority of the fitness as to character and competence of its directors.	Standard of care to be increased from that of a prudent person to that of a prudent director. All directors to be registered with NFAA. Standards of supervision to be increased, including more extensive use of specialized oversight board committees.	
Auditors, actuaries, and appraisers	CDIC to take a leading role in working with the Canadian Institute of Chartered Accountants, appraisal institutes,	CDIC, primary regulators, industry representatives, and the CICA to work together to develop reporting and assessment stand-	Amendments to the statutes governing Ontario financial institutions to require the appointment of an audit committee com-	Actuary, auditor, and appraiser to be engaged by a financial institution under the supervision of NFAA would be required	Auditors to report any material wrongdoing and serious concerns about financial health of institutions.

	member institutions, and regulators to develop accounting and valuation standards. CDIC to have a leadership role in determining uniform examination standards, including programs, frequency, and minimum qualifications.	ards that will more accurately reflect exposure to risk. Financial institutions to be required to submit to annual audits by two firms, one of them appointed by the primary regulator. Auditors to be required to attend the meetings of the audit committee. Auditors to be required to report to the audit committee all instances of self-dealing, malfeasance, and transactions outside the apparent powers of the institution. Copies of the post-audit reports to management and the audit committee of the board to be provided simultaneously to the primary regulator.	posed of outside directors and to impose a general duty upon the committee. The Lieutenant-Governor in Council to be given the power to make regulations that auditors must consider in their deliberations. Amendments to the statutes to require the auditors of a financial institution to: - attend all meetings of the audit committee; - make reports on the work conducted by auditors; - assess the financial stability of institution, as deemed desirable; - and, in particular, to report to the audit committee every instance of: self-dealing; apparent fraud, malfeasance, or other financial irregularity; transactions beyond the powers of the institution; transactions that could have an adverse effect on financial stability; transactions involving a liability that would constitute an off-balance-sheet item.	to obtain prior approval of NFAA. NFAA, in conjunction with the Canadian Institute of Actuaries, the CICA, and the Appraisal Institute of Canada to be encouraged to develop guidelines and standards for financial reporting. NFAA to require these professional groups to establish a review committee on the adequacy of solvency standards. Severe disciplinary measures to be instituted against those advisors who fail to observe the standards and code of conduct.	Auditors and actuaries to be accountable for the accuracy and completeness of their reporting, and regulators have the authority to review their appointments. Management to be liable for quality of information supplied to auditors.
Lawyers, financial planners, and investment counsellors					Lawyers managing estates and trusts, financial planners, and investment counsellors to meet minimum standards of behaviour and to be licensed.

Glossary

Account receivable. An account opened through the purchase of goods and services but not yet settled.

Activity. An investment, a service offered, or a transaction in which a financial institution or intermediary is involved. Examples are the acceptance of deposits, mortgage or commercial lending, and investment in bonds or equity.

"Chinese Wall." A set of rules that prevent information from flowing between different departments of the same institution.

Conflict of interest. A situation in which the interest of one person and the interest of someone else (including a financial institution) acting on behalf of that person are at variance. Such a situation can also occur when someone, acting on behalf of several customers whose interests are at variance, must choose (or at least has the opportunity to choose) to serve the interest of one over the interest of the others.

Co-insurance. A deposit insurance system in which only a proportion – say, 80 or 90 per cent – of eligible deposits would be insured, so that the depositor would bear some risk. Under some proposals, co-insurance would apply only to deposits above some minimum.

Conglomerate. An organization that offers financial products unrelated to each other; for example, an institution that offers brokerage and insurance services, and accepts deposits, would be a conglomerate. According to such a definition, Schedule "A" banks, trust companies, and financial cooperatives are conglomerates.

Cross-lending. Lending by one member of a financial holding group to another member of the same group.

Cross-referral. The referral of potential customers by one institution to another, for further servicing of their needs.

Cross-selling. A form of networking, where the agent of one financial institution sells the products of another institution.

Distribution level. Level at which a financial product is sold to the customer. Insurance and mutual fund salesmen, branches of banks, or trust companies are part of the distribution level.

Early-warning system. A system involving a set of monitoring arrangements, normally based on data supplied by financial institutions and designed to indicate to regulators at an early stage when solvency problems in an institution are beginning to develop. The early-warning system focuses on a number of critical variables, such as capital adequacy, asset quality, management ability, earnings, and liquidity.

Exempt-securities market. A market for securities exempt from regulation by a securities commission; for instance, in Ontario and most other provinces, a securities firm or any financial institution that engages in transactions on government securities or in deals with a value in excess of $97,000 is not required to operate under registration.

Financial futures. A contract that entitles the holder to purchase or sell a security for an arranged price, at a specified time in the future.

Financial holding company. A company whose assets are composed mainly of shares in other financial institutions.

Financial holding group. A group consisting of a holding company that has controlling interest in two or more financial companies operating in different areas of the financial system – e.g., trust companies, life insurance companies, mutual funds, investment counsellors, general insurance companies, and sometimes investment dealers and banks.

Floating-rate preferred share. A share that is similar to a preferred share, except that its price fluctuates very little, since dividends are fixed at about 65 to 75 per cent of the prime interest rate. Consequently, a floating-rate preferred share has the appearance of a bond, but from the point of view of the shareholders, the income generated from such shares is not declared as interest income (as in the case of a bond) but rather as a dividend that entitles the holder to a dividend tax credit.

Function. An activity or group of activities in which a financial institution or financial intermediary is engaged, characterized by a set of criteria that distinguishes it from others. These criteria involve specific management or accounting techniques, specific markets, and/or specific risks. Examples of functions are: banking as defined by the supplying of the means of payment, insurance, and securities dealing and trading. The first two examples are functions defined with respect to the special characteristics of the liabilities of the institutions involved.

Grandfather clause. A clause that exempts an institution from abiding by newly introduced legislation, on the grounds that it was legally engaged in the now-prohibited activity before the law changed.

Interest-rate swaps. A transaction whereby the borrower trades the terms of his debt obligation with another borrower (e.g., floating-rate debt for fixed-rate debt); but the principal of the loan is never exchanged.

Intermediation of funds and risks. The transferring of funds between two economic units, individuals, firms, institutions, or governments. When the transfer involves an intermediary that, in the process, issues a claim on itself, it is called "financial intermediation." Banks are involved in financial intermediation by raising funds through deposits – a claim on themselves. When it involves an intermediary whose only role is to bring the two parties together, it is

called "market intermediation." Securities brokers are involved in market intermediation.

Inventories. Goods held by a firm, for sale at a later date.

Junk bonds. High-yielding bonds that are issued by companies with a low credit rating or by companies wishing to finance highly leveraged takeovers.

Level playing field. A situation whereby all the institutions involved in similar activities are subject to the same rules (e.g., the same reserve requirements apply to all deposit-taking institutions).

Means of payment. Any instrument widely accepted in payment for goods and services and for discharge of debt and other kinds of business obligations [with thanks to D. H. Robertson, *Money*]. The means of payment today include currency and deposits redeemable or transferable on demand. In future, units in security pools may become a means of payment.

Networking. An arrangement whereby one institution provides facilities to sell the products of another institution. This may be accomplished by the one institution leasing physical space to the other institution or by cross-selling.

Non-arm's-length transaction. A transaction between two related parties (e.g., a financial transaction between two institutions associated through ownership links or between an institution and its owners, directors, or managers).

Non-marketable instruments. Financial instruments for which there are no secondary markets where they can be bought or sold after having been issued (current examples: personal or business loans).

One-stop financial shopping. A system whereby a customer can handle all of his financial affairs under one roof. A one-stop financial centre would bring at one location institutions offering deposits, loans, insurance services, securities trading, fiduciary services, financial-planning services, and so on.

Production level. The level within a financial institution at which a financial instrument is designed, adapted to the specific needs of customers, and managed.

Pyramiding of capital base. A situation in which the common stock or subordinated debt eligible to be counted as part of the capital base of a financial institution is owned by another financial institution but not deducted from the capital base of the owning institution.

Reciprocity. In trade negotiations, reciprocity implies an exchange of concessions to the mutual, equal advantage of each party. This should be distinguished from national treatment, where one country's goods, services, or institutions are treated in another country the same as the latter's domestic institutions.

Registered Retirement Savings Plan (RRSP). A savings vehicle that benefits from special tax treatment. Contributions to such vehicles – up to a certain amount annually – are deductible from taxable income, and interest is not taxable on accrual.

Risk-related premiums. Premiums for deposit insurance that are set according to the riskiness of the insured institution; as a result, higher-risk institutions pay higher premiums.

Securitization. A process whereby car loans, mortgage loans, or operating loans are bundled together in security pools, units of which are sold to private or corporate investors.

Self-dealing. A situation that occurs when a conflict of interest results in a harmful non-arm's-length transaction for the sole advantage of the person or institution making the decision.

Short-term deferred annuities. Annuity contracts issued by life insurance companies, in which the annuity payment is deferred, thereby making the contracts very similar to term deposits.

Subordinated debt. Debt, usually in the form of bonds or debentures, that holds an order of priority in the event of a firm's failure or in the payment of interest, above shareholders' equity but below other debt. In the case of financial institutions, subordinated debt would take precedence over deposits, ordinary borrowings, insurance claims, and so on.

Syndicated loans. Loans that, because of their large size, have been undertaken by a group of financial institutions called a syndicate.

Tied-selling. A transaction whereby a customer is required to purchase a second service as a condition of purchasing the first.

Underwriting. The process by which securities (bonds or stocks) or insurance policies are issued.

Universal life policies. Life insurance contracts, with premiums that may be variable at the discretion of the insured and that separate the savings component from the insurance component. In practice, term-life-insurance premiums for face value less accrued savings, based on the company's current rates, are deducted from the premiums paid, the balance of which is invested in a mutual-fund-like instrument, on which interest accrues at current rates.

Background Studies Commissioned by the Council

D. Albert	Les coopératives financières
D. Albert	Institutions financières et insolvabilité – Les facteurs explicatifs
H. Binhammer	Depository institutions: Risk and insolvencies
W. Clendenning	A description and assessment of the provincial regulatory arrangements in the Canadian financial sector
G. Lermer	Regulation of conflicts of interest and self-dealing in the Canadian financial markets
A. Mayrand	Diversification, concentration et concurrence au sein de l'industrie des services financiers
K. Patterson and A. Ryba	Business financing
K. Patterson	Financial services to consumers
A. Ryba	The role and efficiency of the financial sector: From theory to reality
A. Ryba and M. Scinocca	Financial holding companies
M. Scinocca	Investment counsellors, a specialized group that has found a niche

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